

START-UPS STALLING? THE TAX CODE AS A BARRIER TO ENTREPRENEURSHIP

HEARING BEFORE THE COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES ONE HUNDRED FIFTEENTH CONGRESS FIRST SESSION

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WEDNESDAY, FEBRUARY 15, 2017

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 11:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Luetkemeyer, Brat, Radewagen, Kelly, Blum, Schneider, Bacon, Fitzpatrick, Velázquez, Evans, Murphy, Lawson, Chu, Adams, Espaillet, and González-Colón.

Chairman CHABOT. Good morning. I call the Committee to order.

We want to thank everyone for being here. A special thanks to our witnesses who have taken time away from their busy schedules to be here with us today; we greatly appreciate that. We will introduce them here very shortly.

In the coming weeks and months, Congress will have a once-in-a-generation opportunity to pass comprehensive tax reform, the likes of which we have not seen since Ronald Reagan's historic tax reforms back in the 1980s.

While economic indicators remain mixed at best, there is no denying that new business creation remains in a long-term decline. We hear it from our constituents back home and from the witnesses who come to this hearing room to testify every week.

The current Tax Code discourages entrepreneurs from taking the kinds of risks they once did, and this will have serious economic consequences, both in the short-term and in the long-term.

Entrepreneurs face any number of challenges as they try to start a new business, but a recent National Small Business Association, NSBA, survey found that tax regulatory compliance is the number one most burdensome area.

While there are many reasons for this aversion, including Obamacare and overregulation, today's hearing will focus on what is perhaps the greatest barrier to entrepreneurship, our broken Tax Code.

For instance, there are a number of specific provisions in the current Tax Code that directly penalize the risk-taking entrepreneur. In my view, these provisions prioritize government growth through revenue collection over economic growth, and that is exactly the wrong approach. We need to keep the bigger picture in mind.

America's entrepreneurs are crying out for tax relief and this Committee is listening to them. They want a Tax Code that is simpler, fairer, and flatter, so they can start and grow their businesses and turn their dreams into reality. As we work closely with Chairman Kevin Brady and our colleagues on the Ways and Means Committee, this Committee will ensure that small business and entrepreneurship is front and center for any tax reform effort this time around.

The bottom line is that our current tax system is working against entrepreneurs too often when it should be working for them. We have to do better. And fortunately, with A Better Way agenda as our roadmap, we will do better.

Today we will examine specific barriers in the Tax Code to entrepreneurship. We will also explore some possible solutions to tear down those barriers.

I am looking forward to hearing from our witnesses here today, and I would now like to yield to the ranking member, Ms. Velázquez, for her opening statement.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Today, one in ten Americans are self-employed. As we speak, another seven percent of American workers are actively trying to start a business. These trailblazers provide significant benefits to the economy. They take risks to start new businesses, bring new products to market, and ultimately, create new jobs, or even industries. As a matter of policy, we should be encouraging this type of risk-taking. Unfortunately, outdated and increasingly complex tax provisions create obstacles to success rather than a means of stimulating growth and job creation. Today's tax code contains thousands of provisions from the ordinary, like deductions for office supplies to tax credits to advance public policy goals, like the use of renewable fuels. This level of complexity makes complying with the law difficult and expensive, a burden that hits America's entrepreneurs hardest.

This committee is well aware of the challenges created by the Internal Revenue Code and the major complications it has on business planning. Unlike their larger counterparts, many small firms cannot afford to spend significant resources on tax experts to assist them. Instead, many entrepreneurs spend countless hours trying to comply with an arcane tax code drawing them away from their usual business operations. These difficulties bring us to something that everyone on this committee likely agrees upon: importance and value in reforming our tax code. Of course, doing so will be a significant undertaking and the devil will be in the details.

I agree with the chairman that in any comprehensive tax reform, small businesses must be front and center and not an afterthought. One important detail is making sure corporate tax reform also includes changes for our nation's 28 million small businesses. Successful tax reform that simplifies the code will give small businesses greater certainty and allow them to spend their time and resources on what they do best: launching new products and creating new jobs in their local communities.

There have been areas of progress that suggest we may be able to find other common ground in reforming the tax code. This committee was particularly supportive of making permanent a number

of tax extenders, such as the R&D tax credit and Section 179 expensing. Solidifying these changes for the long term gave small businesses certainty, allowing them to plan for the future.

Mr. Chairman, I think all of us understand the vast array of tax compliance challenges facing entrepreneurs. The difficulty will be identifying viable solutions we can all get behind and hopefully implement. This will not be an easy task, but I do hope there is room down the road for cooperation and progress. I look forward to today's testimony, and I thank all the witnesses for the time that you are taking away from your businesses or jobs to be here today. Thank you.

Chairman CHABOT. Thank you very much. Thank you. The gentlelady yields back.

If Committee members have opening statements, we would ask that they be submitted for the record.

And before I introduce our distinguished panel here this morning, just a brief overview of our timing and our rules, which is the 5-minute rule. Each of you will get 5 minutes. The green light will be on for 4 minutes. The yellow light will come on to let you know you have got a minute to wrap up, and the red light will come on, and we would ask that you try to stay within that if at all possible. We will give you a little leeway, but not a whole lot.

So again, thank you for being here this morning. Our first witness is going to be Kyle—is it Pomerleau? Pomerleau, okay, thank you, director of Federal Projects for the Tax Foundation in Washington, D.C. In that capacity, he leads the tax modeling team, oversees the center's research, and researches and writes on a variety of Federal tax issues. His work has been cited in most major media outlets throughout the country.

Our second witness will be David Burton, senior fellow in Economic Policy at The Heritage Foundation. He focuses on a wide swath of economic issues, including tax, securities, entrepreneurship, financial privacy, and regulatory and administrative issues. Prior to joining The Heritage Foundation, Mr. Burton's long career includes serving as general counsel to the National Small Business Association; CFO and general counsel to a startup, Alliance for Retirement Prosperity; partner in the Argus Group; vice president and general counsel to a multinational manufacturer; and manager of the U.S. Chamber of Commerce's Tax Policy Center.

Our third witness today is Tim Reynolds, president of Tribute, Inc., a small software company located in Hudson, Ohio. Prior to purchasing Tribute in 1994, Mr. Reynolds held a variety of management positions with British Petroleum and BP America. He has also held a number of board and leadership positions in small business advocacy and economic development organizations, including previously chairing the Board of the National Small Business Association, NSBA. He is testifying today on behalf of the NSBA.

We welcome all three of you, and I would now like to yield to the ranking member for the purpose of introducing our final witness.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I am pleased to welcome Troy Lewis. Mr. Lewis is an associate teaching professor at Brigham Young University, where he received both a bachelor's and a master's degree in accounting. He is also a sole tax practitioner and the immediate past chair of the AICPA

Tax Executive Committee. He is testifying today on behalf of AICPA. Welcome, Mr. Lewis.

Chairman CHABOT. Thank you very much.

Mr. Pomerleau, you are recognized for 5 minutes.

STATEMENTS OF KYLE POMERLEAU, DIRECTOR OF FEDERAL PROJECTS, TAX FOUNDATION; DAVID BURTON, SENIOR FELLOW, ECONOMIC POLICY, INSTITUTE FOR ECONOMIC FREEDOM AND OPPORTUNITY, THE HERITAGE FOUNDATION; TIM REYNOLDS, PRESIDENT, TRIBUTE, INC.; TROY K. LEWIS, CPA, CGMA, TAX EXECUTIVE COMMITTEE IMMEDIATE PAST CHAIR, AMERICAN INSTITUTE OF CPAS

STATEMENT OF KYLE POMERLEAU

Mr. POMERLEAU. Thank you, Chairman Chabot and Ranking Member Velázquez, for the opportunity to speak about the U.S. tax system and entrepreneurship.

There are millions of entrepreneurs in the United States, spread across nearly every major industry. While every entrepreneur has a different business model and unique concerns, there are a few key characteristics that apply to many entrepreneurs throughout the country.

Entrepreneurs tend to run losses for some time before turning a profit, and some never turn a profit at all. As a result, entrepreneurial ventures tend to be especially risky investments for outside investors.

If they do develop a successful business model, entrepreneurs often seek to rapidly expand their operations and scale.

Ideally, the U.S. Federal Tax Code would be neutral with regard to each of these characteristics. However, this is not the case under current law. I am going to outline four ways in which the Tax Code discriminates against entrepreneurial investment.

First, the tax treatment of business losses. It is often the case that entrepreneurs run losses for several years before turning a profit. Unfortunately, the current Federal Tax Code is particularly detrimental to businesses whose earnings fall into this pattern.

The reason for this is the fundamental asymmetry in the U.S. Tax Code between the tax treatment of business profits and losses. A business that makes a profit is subject to an immediate tax liability in the same year the profit is earned; however, a business that turns a loss is not always entitled to an immediate tax benefit. This is because businesses whose losses exceed income are required to carry over those losses into future tax years when they finally have income.

Importantly, the longer a business has to wait to deduct its net operating losses, the smaller a tax benefit the business receives.

As a result, the Tax Code is inherently disadvantageous to businesses that run losses for many years before turning a profit.

Second, the tax treatment of capital losses. Entrepreneurs often rely on outside investors to provide financial capital for their businesses. Investments in entrepreneurial ventures tend to be risky, and investors may experience a long string of capital losses before finding an investment that produces a substantial capital gain. And just like business losses, capital losses are not always imme-

diately deductible, creating a situation that penalizes risky investment.

In general, taxpayers are only allowed to deduct their capital losses in any given year up to the extent of their total capital gains. Individual taxpayers are also allowed to deduct up to \$3,000 in capital losses beyond those losses. Otherwise, they have to carry forward the remaining into future years where they would be deducted against future capital gains.

Here again, the Tax Code contains an asymmetry. Capital gains are subject to an immediate tax liability, while losses do not necessarily yield an immediate tax benefit.

Third, the tax treatment of business investment. Entrepreneurs that develop a successful business model are often interested in scaling their operations as rapidly as possible. However, the current U.S. Tax Code is especially burdensome on businesses that undertake significant capital investments due to the tax system's treatment of capital investment, or specifically, depreciation. Under current Tax Code, businesses are not allowed to deduct the full cost of capital investments in the first year. Instead, they are required to deduct their investment cost over long periods of time according to a set of over two dozen depreciation schedules.

Because businesses value immediate deductions more than deductions in the future, the longer a business has to wait to write off the full cost, the less likely the business is to undertake a new investment.

Fourth, high tax rates on business income. All three of the previous distortions in the Tax Code are exacerbated by the high marginal tax rates on businesses in the United States today.

Entrepreneurs that choose to set up passthrough businesses, such as S corporations, partnerships, face a top Federal tax rate of 44.6 percent, and the rate can exceed 50 percent when State and local income taxes are taken into account.

Other entrepreneurs may choose to organize their businesses as C corporations. These businesses are subject to two layers of tax. First, a 35 percent corporate tax rate, which is the highest in the developed world, followed by a 25 percent capital gains and dividends tax.

In conclusion, the U.S. code tends to impose higher burdens on businesses that run losses for many years, businesses that are risky investments, and businesses undergoing rapid expansion, all of which are typical characteristics of entrepreneurial ventures.

Lawmakers interested in removing these barriers to entrepreneurship should consider ways to mitigate these distortions in the U.S. Tax Code. Thank you.

Chairman CHABOT. Thank you very much.

Mr. Burton, you are recognized for 5 minutes. If you could turn that mic on. That is all right.

STATEMENT OF DAVID BURTON

Mr. BURTON. Thank you, Mr. Chairman—that's better—Ranking Member Velázquez, and members of the Committee, for the opportunity to be here this morning.

The views I express in this testimony are my own and do not necessarily reflect the institutional position of The Heritage Foundation.

Entrepreneurship matters. It fosters discovery, innovation, and job creation. Entrepreneurs develop new and less expensive products that improve consumer well-being and account for most of the job creation in the United States. Moreover, the vast majority of economic gains from the innovation that entrepreneurship creates accrues to the public at large rather than entrepreneurs.

Most indicia of entrepreneurial health indicate that entrepreneurship is in decline. Accordingly, job creation, productivity improvements, and welfare enhancing innovation have slowed and the tax system is a major contributing factor. It is a factor both because of the direct impact of the tax system on small and startup firms, but also because of the adverse impact on the economy overall. It imposes high taxes on risk-taking, harms the international competitiveness of U.S. businesses, and impedes economic growth. Moreover, the tax system is monstrosly complex, imposing inordinately high compliance costs on small and startup firms.

Among the four major sources of complexity in the tax law are the Capital Cost Recovery System; inventory accounting; employee benefit taxation, particularly the rules governing retirement savings or qualified accounts; and international taxation.

Given our time constraints, I will quickly outline 12 reforms to the current system designed to aid entrepreneurs and briefly discuss tax reform. Many of the incremental reforms proposed raise issues that need to be addressed in fundamental reform as well.

First, Congress should amend Internal Revenue Code section 179 (sic) to permanently allow capital expenses of up to \$1 million to be deducted when incurred. Expensing would simplify small firms' tax returns, reduce compliance costs, reduce small firms' cost of capital, and aid cash flow.

Very few small employers offer retirement accounts because of the complexity, high compliance costs, and regulatory risk of doing so. It is one of the most complex areas of the tax law and desperately in need of simplification.

Evidence shows that capital gains rates much above 20 percent actually reduce Federal revenue. In addition, a high capital gains tax rate reduces the willingness of investors to invest in relatively risky startups and growth companies and impedes capital formation.

Congress should also permit cash method accounting for firms in up to \$10 million in gross receipts.

Congress should liberalize the S corporation rules, particularly allowing S corporations to have more than one class of stock, non-resident alien shareholders, subject to 30 percent withholding, and more than 100 shareholders. This latter issue is particularly important for companies that are trying to take advantage of the recent JOBS Act provisions related to crowdfunding or Regulation A where they are trying to use the Internet to raise small amounts of money from a large number of people. Unless you change those rules, they will not be able to take advantage of it.

Obamacare imposes a health insurance tax that needs to be repealed. This is particularly focused on small companies rather than large companies that self-insure.

We also need to reduce the tax rate paid on passthrough entities to no more than that paid by C corporations.

We need to increase the threshold for ISOs, or incentive stock options.

We need to provide full deductibility of health insurance purchased by the self-insured.

We need to improve the rules and clarify the rules relating to whether distributions are subject to the self-employment tax from passthrough entities.

We desperately need to clarify the rules governing the distinction between employees and independent contractors. That rule has been around there or that problem has been around since the 1970s. It has never been fixed.

And we need to increase the unified credit amount so that family businesses and farms do not have to be sold to pay the estate and gift tax.

Now, briefly, on fundamental tax reform, under the leadership of Speaker Ryan and House Ways and Means Committee Chairman Brady, the House Republicans put together what they call a blueprint. This blueprint would have an extremely positive impact on the economy. Our friends at the Tax Foundation estimate it would increase GDP by 9.1 percent over 10 years, and I think that is about right based on other macroeconomic work that has been done.

It would aid small businesses for at least two reasons. First, it would result in a dramatically stronger economy. And secondly, it would dramatically reduce the complexity and compliance burden experienced by small firms. And I would be glad to get into a lot of those details.

Thank you very much for the opportunity to testify this morning.

Chairman CHABOT. Thank you. You fit a whole lot into 5 minutes there, so thank you very much.

Mr. Reynolds, you are recognized for 5 minutes.

STATEMENT OF TIM REYNOLDS

Mr. REYNOLDS. Good morning, Chairman Chabot and Ranking Member Velázquez, and members of the House Small Business Committee. I want to thank you for inviting me to testify today.

My name is Tim Reynolds. I am owner and president of Tribute, Inc., a software company located in Hudson, Ohio. Our 38-employee company develops and markets accounting and operations software for industrial distributors.

I am pleased to be here representing not only my company, but also the National Small Business Association, NSBA, where I currently serve as an honorary trustee and am a past chairman.

NSBA's members consistently rank tax simplification and reducing the tax burden among their top issues for Congress and the administration address. The compliance burden on taxpayers, because of the complexity of our code, is truly staggering.

My company is a Subchapter S firm. As such, the income of my company flows to my personal tax return. I have an MBA from the

University of Michigan. I run a company that develops and sells accounting software and have been in business for more than 20 years. Yet, I would view it as taking an irresponsible risk to attempt to do my own taxes. The Code is so complicated that I feel certain I would inadvertently run afoul of the law. So I have to pay an accounting firm to do these taxes.

In fact, according to the NSBA 2015 Small Business Taxation Survey, only 15 percent of small business owners handle their taxes internally. Eighty-five percent are forced to pay an external accountant or practitioner. This data point should send a strong message to the IRS and to Congress that the Tax Code is far too complex.

I firmly believe the efforts to reduce the regulatory and administrative burdens on small businesses must focus on overall simplification, eliminating the inequities with the Tax Code and enhancing taxpayer education and outreach.

My company has been audited by the IRS twice. In both cases, the eventual result was no errors found, and therefore, no penalties. In one case, the initial auditor did not understand the rules around deferring software sales revenue. After multiple appeals, we were finally referred to her supervisor, who agreed with our interpretation of the deferral rules.

My point here is that in some cases, even the IRS cannot easily interpret the rules. Tax simplification would reduce not only the cost of compliance, but possibly also the cost of enforcement.

As the tax laws have evolved over the last 30 years, it has become full of often contradictory rules with unclear policy objectives that have resulted in both unintended consequences and unrealized intended consequences.

I will conclude my testimony with an example that has impacted my firm directly. This problem has to do with the impact that the alternative minimum tax has on the R&E tax credit. As a software development company, Tribute spends a significant amount of effort each year on research and development. As such, we are entitled to take advantage of the R&E tax credit, which can produce tax savings available then for more investment and development. However, because we are an S corporation, I am often subject to the alternative minimum tax. For years, this has prevented my company from taking the R&E credit. This credit is meant to encourage additional research and development, yet I am penalized for the way my business is structured.

I should note that the PATH Act of 2015 fixed this problem, but only for C corps. As you may know, most small businesses, where much of our innovation happens, are S corps, and so the complicated Tax Code steps on its own foot yet again in this area.

So in conclusion, the cost of compliance and the complexity and inconsistency within the Tax Code pose a significant and increasing problem for small business and our economy. A simpler, stable tax system dedicated to investment, savings, and economic growth must be put in its place.

Again, I would like to thank Chairman Chabot, Ranking Member Velázquez, and members of the Small Business Committee for the opportunity to speak today. I would be very happy to answer any questions that you might have.

Chairman CHABOT. Thank you very much.
Mr. Lewis, you are recognized for 5 minutes.

STATEMENT OF TROY K. LEWIS

Mr. LEWIS. Chairman Chabot, Ranking Member Velázquez, and members of the House Committee on Small Business, thank you for the opportunity to testify.

We applaud the leadership taken by the Committee to consider ways to promote entrepreneurship by addressing barriers in the Tax Code.

Today I would like to highlight a few tax reform issues that directly impact small businesses and their owners. First, it is important to recognize that tax relief should not mean a rate reduction for C corporations only. Congress should continue to encourage, or at least not discourage, the formation of sole proprietorships and passthrough entities.

If Congress decides to lower corporate income tax rates, small businesses should receive a lower tax rate as well.

We recognize that providing a reduced rate for income to small businesses will place additional pressure on the need to distinguish between profits of the business and compensation of the owner-operators. We should continue to use traditional definitions of reasonable compensation and judicial guidance for this purpose.

To minimize controversy, the IRS should take additional steps to improve compliance in this area. Partnerships and sole proprietorships should be required to charge reasonable compensation. However, we should not treat partners and proprietors as employees, but rather as owners whose labor is also subject to withholding. Including partners and proprietors in well-defined payroll rules should enhance enforcement in this area.

If Congress decides to move forward with the 70/30 rule—and that is treating 70 percent of passthrough income as employment income and 30 percent as return of equity—we urge you to make this proposal a safe harbor and not a hard and fast rule. A safe harbor would promote simplicity for many businesses without sacrificing potential fairness for others.

Next, we are concerned with and urge you to oppose any new limitations on the use of the cash method of accounting. The cash method is a simpler application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income, which is why entrepreneurs often choose this method. Forcing them to switch to the accrual method upon receiving a gross receipts threshold would unnecessarily discourage business growth and impose financial hardship on cash-strapped businesses. We appreciate that Chairman Brady, recognizing the importance of the cash method of accounting, did not restrict its use in the tax reform blueprint.

Another important issue for small businesses is their ability to deduct interest expense. Owners borrow to fund operations, working capital needs, equipment acquisition, and even to build credit for future loans. We should not take away or limit this critical deduction for many small businesses who, with little or no real access to equity capital, are forced to rely on debt financing.

Another potential barrier for small businesses involves changing the rules around the taxation of compensation. Congress should not reduce an employee's ability to deduct the compensation paid to employees, whether in the form of wages or fringe benefits.

At the same time, it is important to retain the employee fringe benefit exclusion. Changes in this area would impact the small business' ability to build and retain a competitive workforce.

Discussions on tax reform have also included border adjustment provisions, suggesting an exclusion of export sales revenue and a disallowance of the deduction for any imported goods or services. These provisions would impact businesses of all sizes, including small business. For example, a growing number of small accounting firms are locally owned and operated but must participate in global alliance networks in order to serve their clients on international tax matters. In other words, border adjustment provisions could have a substantial impact even on small local service providers.

Unfortunately, there are many other tax provisions that hinder small businesses. For example, net operating losses. If passed by Congress, a 90 percent limitation on the use of an NOL imposes an artificial restriction on a company's use of business losses, and it discriminates against companies with volatile income. These businesses could potentially pay more tax than companies with an equal amount of steady income over the same period of time.

We urge you to consider increasing the startup business deduction to give entrepreneurs the startup support they need in the early years, as well as reforming laws for qualified retirement plans and for unfair penalty provisions.

Congress should also repeal the AMT for both individuals and corporations.

Finally, we recommend that Congress permit flowthrough entities to choose fiscal year ends for tax purposes, which would allow advisors to spread out their workloads during the year. This flexibility would help ease the burden on both taxpayers and their advisors.

In my remaining time, I want to ask for your support on the mobile workforce legislation. Employer tracking and complying with all of the different State and local tax laws is complex and costly. We urge you to support mobile workforce legislation that provides a uniform national standard for nonresident State income tax withholding. That legislation would also provide a de minimis exemption from State income tax for nonresidents.

Thank you, and I would be happy to answer any questions you may have.

Chairman CHABOT. Thank you very much.

I would comment that I think all four of the witnesses made great suggestions that I think we ought to seriously consider, and we will obviously pass these on to the Ways and Means Committee also in this process.

So I will recognize myself for 5 minutes for questioning. And Mr. Reynolds, I will start with you if I can. You said that your company was audited twice and neither time did they find that you paid less than you were supposed to. I assume that that was a stressful process to go through, and I imagine it probably cost a lot. Can I

pry and ask you, do you know approximately how much you all ended up paying out of pocket? And also, was there an opportunity cost to you spending all this time doing this so you were not spending it on your business? If you could comment on that.

Mr. REYNOLDS. Well, certainly. There was some level of opportunity cost. In both cases when we were audited, it was important for us to involve our accounting firm in order to represent us as they talked with the IRS. It was particularly important when we had the disagreement with the initial auditor around how to defer software revenue, which took several weeks to actually end up resolving.

So in the first case where there was no dispute, I think it was probably a couple thousand dollars, and in the second case, it was more around \$6,000 or \$7,000 of cash outlay to my accounting firm for their time in representing me.

Chairman CHABOT. Thank you very much.

Mr. REYNOLDS. The audits also, of course, took not only my time but my controller's time, bookkeeper's time, so it was a significant—

Chairman CHABOT. So I am assuming it distracted you from your business. How many employees do you have?

Mr. REYNOLDS. Pardon me? I have 38 employees.

Chairman CHABOT. Thank you very much.

Mr. Lewis, I will turn to you. I have been hearing from some of my constituents back in Cincinnati about business interest deductibility and the proposal in the Better Way agenda to eliminate, do away with it. How critical is interest deductibility to entrepreneurs as they try to launch or expand a business? And what impact could its repeal have on entrepreneurship in general do you think?

Mr. LEWIS. That is a great question. I think you need to realize, to answer that question, a couple of things. Number one, the ability for a small business to flip a switch and grab equity capital is very limited. I know in theory you would like to say, well, you are indifferent. Someone can invest in your company with stock or you can go borrow, but the reality is borrowing is so much simpler and much easier. And that is the lifeblood of these small businesses. That is where they get it.

So from their perspective, this notion that you are going to make it relatively neutral, that you cannot deduct dividends, you cannot deduct interest, will not ring true.

Now, the tradeoff that you hear is you hear, well, you mentioned the Better Way, that you will be able to deduct all of your capital outlays, this million-dollar increase that Mr. Burton mentioned for section 179.

But the reality is these small businesses already have that, by and large. Half a million dollars. It does not solve all the problems, as Mr. Burton said, but they are already expensing. So the only thing you would be gaining in this perhaps is a disallowance of that interest expense. And remember, these businesses run on incredibly thin margins. Most of them have an operating loss up front. There is a time where they know they are going to lose money until they can be profitable, so every dollar matters.

So to answer your question, it is very critical for these businesses, particularly because on the other side they are not really

picking up much in terms of immediate expensing which you might think with a larger company.

Chairman CHABOT. Thank you very much.

Mr. Pomerleau, I will move to you if I can. You mentioned that the current depreciation regime is very complicated, being comprised of more than two dozen depreciation schedules and requiring, I believe, 448 million hours each year for compliance. What is the impact of this on American businesses and the economy, and what do you suggest that we do about that?

Mr. POMERLEAU. Yeah. So one of the big downsides with the current business Tax Code is this idea of depreciation. Requiring businesses to write off assets over a number of years basically reduces the amount they get back in those deductions. So if you could get a deduction of \$100 up front, that is a lot larger of a deduction than if you took that \$100 and spread it over 10 years. We find that if you move from this system to a system of full expensing, I mean, it would grow the economy by about 5 percent over a decade. So this is implying that depreciation under the current system is reducing the level of investment in the economy.

Chairman CHABOT. Thank you very much.

And I will conclude with you, Mr. Burton. You mentioned that repealing the excise tax imposed by Obamacare on health insurance premiums would be helpful to entrepreneurs. Did Obamacare impose any other taxes that are, in your view, hindering entrepreneurship?

Could you turn the mic on again, please? That is all right.

Mr. BURTON. The most obvious would be the Obamacare investment income tax, which is 3.8 percent. And so owners of pass-through entities or for, that matter, shareholders in C corporations would pay it. But there is a fairly long list of taxes that were a part of Obamacare.

Chairman CHABOT. Thank you very much.

My time has expired. The gentlelady, ranking member, is recognized for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Pomerleau, there seems to be agreement that the tax system is overwhelmingly complex. One of the main problems for businesses is deciding on which tax structure, which one of them offers the most advantages. Do you believe that the various options available make the tax law more complicated?

Mr. POMERLEAU. Yeah, I think that that is true. So under current law there are several ways that you could form a business, and those have specific tax consequences. The big distinction, of course, is between passthrough entities, S corps, partnerships, sole proprietorships, and C corporations. So if you are deciding to make an investment, whether it is building a factory or buying a machine that is going to have a return for you, it matters what business form you go into. If you go into a C corporation, you may face a double tax. If you go into an S corporation, there are limitations there even if you do not face the double tax. So I do think that under current law there are a lot of calculations that business owners need to do that would not be necessary under a tax system that treats all investment equally.

Ms. VELAZQUEZ. Thank you.

Mr. Lewis, can you please describe the complications that pass-through entities may face in net operating loss calculation, and what can we do in Congress to address it?

Mr. LEWIS. Okay. Thank you for the question.

What happens, as has been said, when you have a passthrough entity, by definition that means the income of the business, although it is reported by the business, is passed through or, in other words, reported directly by the owners themselves. And most of the time, particularly in a small business setting, we are talking about individuals.

So your question is if a business is owned by a bunch of individuals and they have a loss, how does that impact them individually? And the answer is when you file an individual 1040, a business return into a 1040, you have two aspects. You have sort of like their personal aspect and then you have the business. And it is that interplay in between those two that creates the complexity.

In a C corporation, as has been mentioned, it is relatively straightforward. If you lose money, the number kind of falls out. But in an individual standpoint, there is an entire IRS publication that takes you through how to separate out the business side of your dealings from your individual side, from your personal side.

So some of the things that you could do would be to simplify the rules and maybe just say, all right, whatever the loss is coming from the business, without making adjustments, just recognize that in simplicity sake you might give up some equality issues, but you would gain a lot by simplicity. I think the theme that I have heard from the panelists that bears repeating is simplicity is the key. A lot of these small businesses are drowning in regulation, particularly from the tax side, and they need relief. They need to have more time, as Mr. Reynolds said, to spend on developing the software and finding customers than trying to comply.

Ms. VELAZQUEZ. Thank you.

Mr. Reynolds, in your testimony, you make note of the tax extenders passed into law in 2015 under the PATH Act. We have heard that 100 percent exemption of capital gains on investment in qualified business stock passed under this act has catalyzed investment in innovative startups. Would you be in support of allowing small businesses operating as LLCs to qualify in addition to corporations currently allowed?

Mr. REYNOLDS. For the section 179?

Ms. VELAZQUEZ. Yes.

Mr. REYNOLDS. Yes. Yes, ma'am. I certainly would.

Ms. VELAZQUEZ. Mr. Pomerleau?

Mr. POMERLEAU. Yeah, I think that treating businesses across the board in the same way is important.

Ms. VELAZQUEZ. Mr. Lewis?

Mr. LEWIS. That is a really fantastic question. The ability under 1202 to exclude the 100 percent gain after 5 years—that is what you are referring to—yeah, I mean, there are several provisions in the Code where you should be entity neutral and this is one that is clearly patently not. And as a result, I think you have hit a very good point that should be explored.

Ms. VELAZQUEZ. Okay. Thank you.

Mr. Chairman, I yield back.

Chairman CHABOT. The gentlelady yields back.

The gentlelady from America Samoa, Mrs. Radewagen, who is the chairman of the Subcommittee on Health and Technology, is recognized for 5 minutes.

Mrs. RADEWAGEN. Thank you, Mr. Chairman.

I, too, would like to welcome the panel for being here today. Very interesting testimony.

My first question is, and any one of you or all of you could answer it depending on the time, most of the proposals that are being talked about today will only affect the 50 States and the District of Columbia. What proposals do you have for the five territories? Guam, the U.S. Virgin Islands, the Northern Marianas, and America Samoa have a mirror Tax Code to the U.S., and Puerto Rico has a different Tax Code.

Mr. Pomerleau?

Mr. POMERLEAU. I think that I am not really an expert on any of the territories' Tax Codes, but I think any of these issues can be applied to any of the territories' tax systems. It would be worth considering in any reform to improve business taxation.

Mr. BURTON. Puerto Rico and American Samoa have greater flexibility under the law than other territories. To the extent the Congress drafts a pro-growth Tax Code, it will benefit the possessions that have mirror systems. American Samoa and Puerto Rico have the opportunity to adopt pro-growth simpler Tax Codes on their own initiative. I have some familiarity with Puerto Rico, not so much with American Samoa. And Puerto Rico's tax system is highly destructive and counterproductive and has had a very adverse impact in the island's economy. And they really need to reform it.

But the basic themes of what any good tax reform proposes to be is it should lower marginal rates. You should move towards expensing of capital, and you should have a simple system. If you get those basic three things right, you are likely to have a positive impact on entrepreneurs.

Mr. REYNOLDS. I cannot speak as a tax expert, but what I would say as a business person is that anywhere in the world in business, complexity equals cost. And whether it is government or business or the Tax Code, complexity equals cost. And to the extent that you can simplify your Tax Code. I think you will greatly benefit your economy and the businesses there.

Mr. LEWIS. Chairman Radewagen, I think from an America Samoa perspective there would be a couple things I would suggest. Number one, as the House is considering this so-called border adjustability, because America Samoa and Puerto Rico and the other possessions are sort of in this high-risk situation, I think it would be critical to define whether or not those would be treated for domestic or international purposes if you proceed with the border adjustability. In other words, is a sale into or outside of America Samoa going to be deemed to be a sale to a foreign jurisdiction? Or is it going to be within the United States? And I think you can have an appreciation of the kind of severity that that might have. I think that would be one key thing as you are looking. Because, again, as I testified, border adjustability will impact small businesses as well as large. We live in a very global society where all

you need is an Internet connection and you are an exporter. So I think that would be the first thing.

The second thing related to small business is the fact that the way the filings work, the fact that the citizens of the possessions have Social Security numbers and a couple of years ago we saw a lot of ID theft because crooks would figure out if I can grab those Social Security numbers, they are not going to be the ones filing a U.S. return if they do not have U.S.-sourced income. I think potentially what we could work towards with the IRS is making these so-called IP PINs, these identification numbers that are available in the event that you have had ID theft. Right now those are pilot programs only in Georgia, Florida, and the District, where it is voluntary. If you have been subject to theft anywhere else you can grab one, but I think that would go a long way to helping protect the citizens of your possessions.

Mrs. RADEWAGEN. Thank you, Mr. Chairman. I yield back.

Chairman CHABOT. Thank you. The gentlelady yields back.

The gentleman from Pennsylvania, Mr. Evans, who is the ranking member of the Subcommittee on Economic Growth, Tax, and Capital Access, is recognized for 5 minutes.

Mr. EVANS. Thank you, Mr. Chairman.

I would like to thank all of the people on the panel today.

Mr. Lewis, we have heard from small businesses the need to make certain tax credits permanent. How does this temporary nature of the tax provision affect small businesses?

Mr. LEWIS. Mr. Reynolds spoke to it, particularly section 179. Let's look at that expense first and it will answer your question. If you look at section 179, the last time it was passed with the PATH Act in 2015, December 18th. That left about as much time as the shelf life of a carton of milk. Okay? So just 2 weeks. It is really hard to react to that. And so what you find is that you find that your constituents will be paralyzed. They will not assume anything until it is passed, and then at that point they have got the holidays. It is very difficult to put stuff into place.

One of the things about good tax policy is certainty. So to answer your question, if you give the taxpayers certainty and you give them a playing field that they know that they can rely upon, they will react to it. So if you are trying to motivate them with a credit, whether it is the R&D credit like Mr. Reynolds's company, or some of the other credits, if you want to embrace energy credits or something else, the element of certainty is what trips the switch and allows people to react. If not, they will just sit back on the sideline and either discount what might happen or simply just be paralyzed and do nothing.

Mr. EVANS. I kind of want to follow up to a degree. Deducting business startup costs can be complicated. What tax simplification methods could be taken to ease some of that complexity?

Mr. LEWIS. Okay. So the Code section that deals with that is 195. And what happens is, I think as you realize, is from the time a business is organized until they open their doors and get their first dollar, kind of on the shadowbox behind the register, between that time period, the Code currently now makes us capitalize all that and recover it over some period of time. Shockingly, that period of time is 15 years. So you could expense up to \$5,000, but the

rest of it you have to recover over 180 months. That is a long time to not receive that benefit back to an entrepreneur who is worrying about making payroll the next month.

So one of the things you could do is—why is \$5,000 the right number? Why not think about increasing that number? Five thousand seems arbitrarily low when you consider that just to get the doors ready to open it can be a big number, it can be a big amount. So one of the things you could do is expense. Allow these startup businesses to expense a lot larger than \$5,000 and let them get immediate recovery for those costs to get the doors open.

Mr. EVANS. Mr. Burton, how do you respond to concerns that lowering the corporate tax rate will disadvantage small businesses, perhaps stifle entrepreneurship?

Mr. BURTON. I do not think lowering the corporate rate disadvantages small businesses in a sense. Some small businesses are C corps, but you want to try to have a tax system that treats pass-through entities and C corporations as closely as comparable as possible. Obviously, a disproportionate number of small businesses are passthroughs, so I have maintained that any tax reform plan has to take care of passthroughs as well as C corporations, and that the rate that passthroughs experience should be no higher than that of C corporations.

And there was a period about 2 years ago where that was about to be forgotten. I do not think it is as serious a problem now. I think Congress has become much more conscious of that issue.

Mr. EVANS. In your written testimony you stated that the Tax Code is riddled with special tax preferences. Please elaborate on the key tax preferences that put small businesses at a disadvantage.

Mr. BURTON. Well, there is a list of them put out every year by the Treasury that is in the Federal budget, and by the Joint Committee. It is called the Tax Expenditure List. However—there is a really big however here—only some of them are what I would regard, and I think most tax experts would regard as genuine tax expenditures. Some of them relate on a very different conception of what is income, but they would include things like the various alternative energy tax credits. They would include things like the low-income housing tax credit. They would include things like the exclusion for employer-provided health insurance and all the various other employee benefits. And the list goes on in small micro type and it is probably several hundred long.

Mr. EVANS. Thank you, Mr. Chairman.

Chairman CHABOT. Thank you. The gentleman yields back. Thank you.

The gentlelady from Puerto Rico, Ms. González-Colón, is recognized for 5 minutes.

Ms. GONZALEZ-COLÓN. Thank you, Mr. Chairman. Thank all of you for coming to the hearing today.

Small businesses make up a large part of Puerto Rico's economy, as you may know. According to the SBA, about 80 percent of the private sector workers in Puerto Rico are employed at small establishments, which is slightly higher than the percentage of U.S. Mainland. Specifically, more than half a million workers are employed by 45,000 small businesses. In that account, as we draft a

new tax plan, Congress should continue to be mindful of the fact that Puerto Rico and the other territories are U.S. jurisdictions and home to U.S. citizens who are nationals, and that jobs in Puerto Rico and other territories are American jobs.

Mr. Burton, you are very familiar, as you already said minutes before, but some of the disadvantages that Puerto Rican businesses face vis-a-vis is their mainland counterparts, right?

Mr. BURTON. Very familiar is probably too strong. Familiar, yes, although I do not think the vast majority of the problems come from the Internal Revenue Code. It comes from the Puerto Rican tax system itself. As you know, most Puerto Rican businesses are exempt from income taxes, and instead of that, the Commonwealth of Puerto Rico imposes very high corporate taxes, radically higher than any other State or territory. And in addition, there are a host of other taxes. So the Puerto Rican Commonwealth tax system has an extremely negative impact on businesses, entrepreneurs, but also the Puerto Rican people. And the Commonwealth government needs to fix that.

Ms. GONZALEZ-COLÓN. I agree with you 100 percent. That is why the new government just filed a new tax reform system to the island that is supposed to help the small businesses.

Mr. Pomerleau, you mentioned that the top rates on capital gains and dividends, both at 25 percent, are the highest there have been since 1997 and 2002. What will be the ideal rates for optimum growth?

Mr. POMERLEAU. It all depends on how you structure your Tax Code. So one thing to remember is that capital gains and dividends is a second layer of tax on corporate investments specifically. So, depending on what you do on the corporate side is going to bleed into what you are going to want to do on individual investment income. For example, there are proposals that can lower the tax rate at the entity level, so lower the corporate tax rate, but then when that income is passed through, you may raise the tax rate on individual investors so the tax rate is equalized or treated more similarly to wage income. But it all depends on your proposal.

Ms. GONZALEZ-COLON. Thank you.

Mr. Chairman, I yield back.

Chairman CHABOT. Thank you. The gentlelady yields back.

The gentlelady from North Carolina, Ms. Adams, who is the ranking member of the Subcommittee on Investigations, Oversight, and Regulations, is recognized for 5 minutes.

Ms. ADAMS. Thank you, Mr. Chair, and thank you, Ranking Member Velázquez, for hosting this hearing on the complexity of the Tax Code and its impact on our Nation's small businesses.

The State of North Carolina has over 800,000 small businesses, and the City of Charlotte, which I represent, is a great example of an innovation hub for many startups. So guaranteeing that these companies and entrepreneurs have a good understanding of the Tax Code is extremely important. So my questions will focus around our discussions on tax reform and how it can help our Nation's small businesses.

So to start, I would like to give each of you an opportunity to share your thoughts on which elements of tax reform that promote

startups and innovative businesses should be included in the discussions as we move forward here on Capitol Hill.

Mr. POMERLEAU. Yeah, so I think that tax reform proposals that could help small businesses (1) expanding expensing which is in the House GOP blueprint; (2) better treatment of net operating losses. This is another proposal that is in the House GOP blueprint. Now, it does limit the amount you can take every single year, but it also allows you to carry forward those operating losses on an unlimited basis, so as far as you want, and it adjusts those losses for the cost of capital and inflation every single year so they do not ever lose value. Because one of the big problems here with the current code is the longer you have to wait to use your net operating loss, the lower the value is and that is important for entrepreneurs to have lots of losses over many years.

Lower marginal tax rates would also be beneficial. Right now some business forms can face rates up to 44 percent or even higher in some States and lowering those rates down at the Federal level could help.

Ms. ADAMS. Mr. Burton?

Mr. BURTON. I agree with everything he said. I think there are some things he left off. Inventory accounting is a major complexity problem particularly for stores. It can get ridiculously complex, including the uniform capitalization rules, all the separate tracking, whether you are using LIFO or FIFO, and I am sure our friend from the AICPA could go into a great deal more detail.

But also, I think capital gains rates matter a lot to the ability of entrepreneurs to be able to raise capital because they affect investors. And there is also the secondary factor: Once capital gains rates get above about 20, it actually costs the Federal Government revenue because people do not realize their gains.

The other thing I would say is you sort of need to draw the distinction between small businesses that are not startups and others. And retirement savings and qualified accounts probably do not matter much to a guy who is rolling dice and starting a business those first couple of years, but a business like Tim's that has been around for a while, has employees, trying to think through retirement savings for his workforce and himself, the current complexity of the qualified account area has been extremely destructive. It is why so many small businesses do not provide retirement savings vehicles for their employees or for their owners. And we need to address that. It has become genuinely monstrously complex and it serves no real policy objective, no matter what your political philosophy.

Ms. ADAMS. Mr. Reynolds?

Mr. REYNOLDS. I agree with everything, but if I were to pick one thing, I would say that the efforts to level the playing field between passthrough entities and C corporations is quite critical, particularly to startup and small businesses. But I would say the overall metric around the comprehensive tax reform needs to be about simplification. We have a Tax Code that is 70,000 pages. If you could take it down to 35,000, I still would not be able to read it all, but it would be a big improvement.

Ms. ADAMS. Mr. Lewis?

Mr. LEWIS. I would, of course, echo what others have said, but I think philosophical simplification is the right word. Let's keep it simple. I think all of us would agree it is too complicated.

What are some examples of that? Keep cash method of accounting. I think an entrepreneur can understand when I spend something, when I get something, that is when it is taxable. The complexity really comes into it when you start adding into this, well, when was it earned? They can follow their checkbook. It is much more harder, and that is where you start having to get additional people involved to help support. I think that is the philosophical view that would help with all of these issues.

Ms. ADAMS. Thank you very much, gentlemen. I yield back, Mr. Chair.

Chairman CHABOT. Thank you. The gentlelady yields back.

The gentleman from Pennsylvania, Mr. Fitzpatrick, is recognized for 5 minutes.

Mr. FITZPATRICK. Mr. Pomerleau, how are you? Regarding the tax rates for both capital gains and dividends, it is pretty high right now. What would you suggest a sweet spot would be to maximize growth and investment? What is the best rate based on your studies?

Mr. POMERLEAU. So we have not studied this specifically, but David Burton has brought up that, at some point, the marginal tax rate on capital gains starts losing you revenue because people will delay realizing those gains in order to avoid the tax. So what you see looking at historical data, as David said, is the closer you get to 20, the better off you are. So if you start going higher than where we are now or, well, we are basically over 20 now, you may actually be losing revenue in the long run because people are delaying their realizations and pushing the gains into the future where they are going to yield less revenue for the Federal Government.

Mr. FITZPATRICK. So no suggested rate to maximize investment?

Mr. POMERLEAU. I do not think there is a specific sweet spot. I do not know if David may know.

Mr. BURTON. Twenty percent should be the top. It is not the ideal rate because beyond that it not only has economically counterproductive effects, it costs the Federal Government revenue. Now, it might be 22, but that is an absolute top.

In terms of the ideal rate, ideally, you are trying to move towards a consumption tax, or stated differently, a tax that does not double tax savings and investment. And it depends on the administrative structure that you choose how you treat it. If you treat all savings, for example, in an IRA-type treatment, then reinvesting capital gains would, in fact, pay nothing and it would only be when you withdraw it and do not reinvest it, and then you pay the ordinary income rate and other sales taxes like, for example, excuse me, other consumption taxes like, for example, what Chairman Brady has proposed. Financial transactions in principle are entirely disregarded.

Mr. FITZPATRICK. I yield back.

Chairman CHABOT. The gentleman yields back.

The gentleman from New York, Mr. Espailat, is recognized for 5 minutes.

Mr. ESPAILLAT. Thank you, Mr. Chairman. Thank you to the witnesses, Ranking Gentlewoman Velázquez, for this opportunity.

Mr. Lewis, startup businesses are often saddled with great cost, particularly since many of them are renters. And so when folks are about to start a new business they have to significantly invest in major capital improvement to the properties, which often leads them to have issues when they renew their lease because they have, in effect, invested in increasing the value of those properties. Do you see any real benefits, tax credits or other types of benefits, that can alleviate small businesses from this initial investment that very often leads to them shutting down before they even open? Are there any real practical proposals that you have that would alleviate that investment?

Mr. LEWIS. Great question. From a policy standpoint, the AICPA does not have an official policy, but let me give you a sense of some ideas that you could look at, one of which is the section 179 we mentioned. Historically, it was just for personal property, stuff that you could take with you for lack of a better phrase. But on top of that there is some liberalization of that rule where you can expense more of what you are talking about. Allowing entrepreneurs to immediately expense on those initial outlays would help a lot because really, when you are talking entrepreneurship, you are talking cash flow. I mean, all the rest of this is great, but that is what matters to them. Their ability to make payroll is dependent upon their ability to keep the cash coming in. So anything that you can do to give them an immediate benefit back would be well received.

Mr. ESPAILLAT. Thank you.

My second question is regarding the empowerment zone, so what created in the past and what created in distressed urban and rural areas, and they provided tax credit to the tunes of \$3,000 per employee hired within the zone. It provided monies for bonding authority. It also provided a serial tax on capital gains and the sale of assets and other types of benefits for several regions throughout the country that were economically distressed and had high levels of unemployment rates.

How do you feel about this policy to provide tax credits for employees that reside within economically distressed areas? And do you see this as a good policy for spurring businesses and job creation?

Mr. LEWIS. Is that for me?

Mr. ESPAILLAT. Yes.

Mr. LEWIS. Okay. Thank you.

The AICPA put out several years ago something called Good Tax Policy, and we just recently updated it last month. Many of your staffs might be aware of it, but we listed 12 ideas that as you approach any tax question you ought to think in terms of. Things like neutrality, simplicity, transparency, minimizing the tax gap, things that you would just say these are fundamental key components of what we should be doing.

So your question is a good one in that you are asking a question about the balance between simplicity, neutrality, maybe even cer-

tainty and convenience of payment. So my answer would be you would have to weigh all of those together, because if you just isolate the one question and you just say, well, is it good from this policy or that, I think you may not get the right answer. But you have to ask yourself where does it fit in the purview of all of the good policies and evaluate it that way.

Mr. ESPAILLAT. Thank you. I yield back my time.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentleman from Iowa, Mr. Blum, who is the chairman of the Subcommittee on Agriculture, Energy, and Trade, is recognized for 5 minutes.

Mr. BLUM. Thank you, Chairman Chabot. Did I get that correct?

Chairman CHABOT. You did.

Mr. BLUM. I am slow but trainable. It took me 6 weeks to get that correct.

Chairman CHABOT. I even got Blum right. Everybody else says "Bloom," so.

Mr. BLUM. We are making progress.

Chairman CHABOT. Excellent.

Mr. BLUM. And thank you to the panel for being here today, particularly Mr. Reynolds. I happen to be an entrepreneur in the software business myself, and one of my basement companies in the 1990s went public in spite of the government. So I feel your pain.

New business startups, 615,000 in the year 2005, 615,000. Ten years later, down to 450,000, down 40 percent. New jobs from new businesses, 4.7 million in the year 2000, down to 3 million 15 years later. U.S. startups are at 40-year lows.

So I would like to back up and talk a little bit about the formation of small business as it relates to tax policy. The only two ways I know to start a small business as far as capital goes is owner's equity; you put your own money into it and you go to the bank for capital. And if I walk through this—and I will take my own example—you are working for someone else, typically, unless you inherit money. You are working for someone else. You live beneath your means and you save some money. You put that money in a savings account in a bank and the interest is taxed.

So then you put some of the money that you have saved over a lifetime, typically, maybe in the stock market. And then you sell those stocks and the capital gains, you are taxed. You are taxed on your interest. You are taxed on the capital gains.

And then you think, okay, I have got some money here to start a business. Do I really want to go into it? Odds are I could get sued. Nuisance lawsuits. We need tort reform. Regulations are out of control. Do I want to deal with that? There is a multitude of things; also, taxes.

So I would like to ask the panelists, and Mr. Reynolds, I would be interested in your personal story, what can we do as a Congress with tax policy to encourage savings? It seems to me that we discourage savings and encourage consumption in our tax policy. You cannot start a business without capital, and banks are not going to loan it all to you to start a business. So we need to go to the front end of this and say how does our tax policy encourage savings? Because that is where future businesses come from.

And I will open it up to whoever wants to jump in.

Mr. POMERLEAU. I think that that is an excellent question. There are a lot of places in the current Tax Code where the Code is discouraging savings, basically double taxing or triple taxing savings; the issue of dividend taxes, capital gain taxes. You say you earn \$100 in wages. You save that money. Or you get taxed on those wages, you save that money, you earn a return, and then you are taxed again when you take that out as a gain. I think fundamental tax reform should move away from this system of double taxing savings towards a single layer of tax on saving and investment so people are not discouraged from saving. And that means it will not bleed into lower investment and lower economic growth, which is one of the big issues under the current Tax Code.

Mr. BLUM. Would you agree our Tax Code discourages savings?

Mr. POMERLEAU. Yes. I think—

Mr. BLUM. Not a good thing for business formation?

Mr. POMERLEAU. Yes. I think the things that expand IRAs, 401(k)s, that would encourage savings. I think that fundamental reform that moves to a consumption-based tax would do the same. I think the House GOP blueprint moves much closer to an ideal system there.

Mr. REYNOLDS. I would just say that you cannot use an IRA or a 401(k) to start a business. And we can debate whether or not that is appropriate or not.

Mr. BLUM. If I could interrupt, Mr. Reynolds, how did you finance your business when you started?

Mr. REYNOLDS. A combination of savings and loans. And that was 22 years ago and it was considerably easier then.

I think that the Tax Code is one part of the problem in that particular circumstance. I think certainly a shift towards consumption-based taxing rather than taxing on income would go a long way to help that problem.

I think that as a small business person, access to capital is an extremely important issue, and Congress over the last 8 years has done considerable damage to small businesses' ability to get loans and access capital, and I think that that is something that needs to be addressed perhaps outside of the Tax Code, but it is a very vital issue to us.

Mr. BLUM. And I was on a bank board, a billion-dollar bank back in Iowa, and I was chairman of the Director's Credit Committee. Every business loan over a million dollars came through our committee. And part of the problem with extending or making loans to new businesses was they were not creditworthy because they did not have enough equity to put in it. But as we are talking about it here, we tax away a big chunk of this equity as people are saving, as capital is forming along the way.

Chairman CHABOT. The gentleman's time has expired, but, Mr. Burton, if you wanted to respond.

Mr. BURTON. I just want to mention one thing. I released a paper yesterday that systematically walks through the reform agenda to improve entrepreneurs' access to capital, both in the banking and securities regulation area. You might want to look at that.

Mr. BLUM. Very good. I will. I yield back, I guess, the time I do not have.

Chairman CHABOT. Thank you. The gentleman's time has expired.

And the gentleman from Florida, Mr. Lawson, who is the ranking member of the Subcommittee on Health and Technology is recognized for 5 minutes.

Mr. LAWSON. Thank you very much, Mr. Chairman.

My question will be do you think the intangible tax on property should be eliminated? On personal property in the office?

Mr. BURTON. You are talking at the State and local level?

Mr. LAWSON. Right.

Mr. BURTON. In general, yes, I do. I think that particularly the way that they are usually administered, they are very complex and bordering on random. But of course, that varies tremendously State by State.

Mr. LAWSON. Right. And the reason why I question it is because I have been in small business for 36 years and you pay more money to the CPA to do the reports than sometimes what it calls for the taxes. And I want to make sure that I was not the only one that felt that way.

Mr. BURTON. Well, I think you are right. And then a lot of jurisdictions have these little gross receipts taxes, little inventory taxes, just little this, just little that, and the compliance costs relative to the money raised by the State and local government is very, very high, and the State and local governments need to simplify their tax systems as well. That is part of what guys like Tim experience. It is not any one rule or any one tax. It is the combined weight of hundreds of them. And basically, when you add it all up, they are overwhelmed. And we need you as a policymaker and your colleagues at the State and Federal level, you need to systematically try to reduce these burdens. And it is not you want to raise X dollars or Y dollars, just do it simpler.

Mr. LAWSON. Right. Mr. Chairman, I have one more question.

Back in I would say maybe July through September, there was a considerable amount of discussion about the minimum wage increase and there was some major corporation, like McDonald's and some people, really were focusing in on it and said, you know, we can ask for as much as \$15 an hour. The minimum wage increase, even though you want people to have a livable wage, increasing the minimum wage has sometimes a devastating effect on small business, and any of you all can respond to it.

Mr. REYNOLDS. I am in the software business and none of the people that work for me make the minimum wage. They are all on salary. My customers, however, are industrial distributors and often have people who are working minimum wage jobs in the warehouse and all. I think that, if I can speak for them, which they may or may not want me to, but if I can speak for them, I think that they would say that raising the minimum wage impairs their ability to hire additional people in those kinds of jobs.

Mr. LAWSON. And I think, Mr. Lewis, you have done research in that area?

Mr. LEWIS. We have not. It might be more for the economists.

Mr. BURTON. The minimum wage affects a relatively small hunk of our population, but the real question is do you want to make it illegal for typically young people or inexperienced people to work at a lower wage, lower than whatever minimum wage is you pick? It is necessarily going to result in some unemployment of those people. It is necessarily going to result in somewhat higher cost to the employers. But I think the right way to think about it is it is targeted at the people who most need employment experience to do better. And we want a system that lets people get on the first rung of the ladder, and, typically, the minimum wage affects the youngest and least experienced people in the labor market.

Mr. LAWSON. Okay. I yield back my time.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentleman from Nebraska, Mr. Bacon, is recognized for 5 minutes, finally.

Mr. BACON. I want to thank you all for being here today. As a 30-year Air Force guy, you are really making it clear the complexity that our small businesses go through, so I really appreciate that.

And I want to maybe just make a note to Mr. Pomerleau, too. I just thank you for your comments on capital gains. I find it fascinating that—or actually terrible that we have the highest capital gains tax since the 1990s and it has not only had a negative impact on our businesses, but it does not help out our tax revenues. Do I copy you right on that?

Mr. POMERLEAU. No, I agree with that.

Mr. BACON. All right. So that is important. We need to fix that.

And Mr. Burton, I wanted to ask you about self-employed when it comes to ACA and health insurance. It is probably the number one thing I hear from our self-employed that that is the number one thing we have got to fix is the cost of premiums. And right now I believe it is partially deductible. Could you give us recommendations of how we could fix this better for self-employed when it comes to the ACA revisions? How can we get this right for the self-employed?

Mr. BURTON. One thing is the tax treatment. You just want a deduction for purposes of the self-employment tax, the 15.3 percent self-employment tax. But the other question is just the structure of the current health insurance market. Small employers and self-employed people are either not group insurance or very small group insurance and, therefore, tend to, given the structure of the current marketplace, have much higher costs. And part of that is the Affordable Care Act and part of it predates that. It was not as if a group of two or three people had it great before the Affordable Care Act. It is just worse now.

And so that I think it is a matter of changing the structure of the health insurance market, making it less bureaucratic, more competitive. And my colleagues at The Heritage Foundation have put together a number of proposals to do that. I know enough about it to be dangerous, but I am not fully informed of the current state of play, if you will, so.

Mr. BACON. Well, thank you. I talked to a self-employed couple yesterday, with some constituents. They are paying \$30,000 a year,

\$12,000 deductible. It is the highest I have heard yet, and that is hard for a self-employed family.

Mr. BURTON. It is. And I was on my own until about, I do not know, I guess it is going to be 6 years ago now. And the premiums then, and in a small firm were ridiculous. And now they are even more ridiculous.

Mr. BACON. Mr. Reynolds, I wanted to follow up with a comment you made. You are right, about 70,000 pages of tax law. In fact, I think I read it was 78,000. How much time and money does it cost you and your company to work through all the—you know, to do your taxes?

Mr. REYNOLDS. Well, as I said in my testimony, we simply cannot do our own taxes, and so we employ an accounting firm to prepare our taxes along with our annual review. Despite the fact I am a sub S, we have to do both corporate tax submission and a personal one as well, and they clearly have to relate to each other. And so my accounting firm does both. And I think for 2015, the bill came in at about \$15,000.

Mr. BACON. One last question. If you could immediately expense capital investments now rather than having to depreciate them over time, what additional investments would this allow your company to make? What kind of impact would it have if we fixed this?

Mr. REYNOLDS. We are a services firm, so we do not have a lot of fixed assets. But what it would do if I can add, the kind of capital investments that we make generally are around the improvement of our facilities and making a better workplace would certainly accelerate our plans around that. I think, you know, we are a small business and we have to parcel things out over a period of time and it will allow us in general to act much more quickly.

Mr. BACON. Thank you. Mr. Chairman, I yield back. Thank you.

Chairman CHABOT. The gentleman yields back.

The gentlelady from California, Mrs. Chu, is recognized for 5 minutes.

Mrs. CHU. Thank you, Mr. Chair.

Well, there are many current tax policies that create inequities between small and large U.S. businesses, so I would like to address this question to Mr. Lewis. Certainly, the two most consistent burdens for small businesses are the cost of complying with tax provisions and the growing complexity of the Tax Code. I saw this firsthand as a member of the Board of Equalization in California, which was our State's elected tax board.

We saw that too many small business owners had difficulty taking advantage of credits that they qualified for because of the complications. The IRS National Taxpayer Advocate found that the requirements of the Tax Code were so difficult that individuals and businesses spent 6.1 billion hours a year and this resulted in \$163 billion spent in compliance costs. So how does this complexity create advantages for firms that can devote resources to identifying tax loopholes?

Mr. LEWIS. Well, I think one of the fundamental things to recognize is that the complexity impacts not only the large companies, but also the small, and so it impacts them both. The severity would depend upon their circumstances and their industries.

To give you an example, the Small Business Health Tax Credit that was part of ACA, relatively ineffective in terms of compliance because it is rather complicated. So even those who could qualify for that credit found it difficult to comply because of all the requirements and everything that went into it. So sometimes in our efforts I think to create incentives congressionally speaking, I think we need to always consider the implications of simplicity in them because right now to your point, there are a lot of credits out there and incentives that I think people do not avail themselves of because they simply are not aware.

Mrs. CHU. And let me now ask about tax extenders and tax certainty, Mr. Lewis. Often Congress passes legislative modifications to this Tax Code in the form of tax extenders at the end of the year. However, the uncertainty surrounding which tax relief provisions will be renewed makes planning for startups and small businesses difficult. In fact, it was not until 2015 and the PATH Act that Congress finally extended some very important tax provisions, like the research and development credit and the section 179 expensing and made it, in fact, permanent. So how does this uncertainty impact small businesses and startups who are attempting to plan financially for the future?

Mr. LEWIS. Yeah, you hit on a great point. Companies and individual owners of small businesses simply will not react. There are three ways you can do it. One, you can just be cavalier and go cowboy as it were, and you can just assume that Congress is going to do what they are going to do and go with it. But that is not most small business people's fate. They live by cash flow. They cannot just guess.

So to your point, in 2015, what I observed personally is I observed a lot of people sitting on the sidelines, waiting and waiting, constantly calling their CPAs or their tax providers and asking at what point are we going to have certainty?

December 18th, and let's be clear, for those purposes you mentioned, the section 179, it is not good enough to just simply charge the equipment and you are good for the year. You actually have to put it in service. So think about what your life is like on December 18th or 19th and how much flexibility you have in those 2 weeks' time period between then and the end of the year to buy, receive, and actually put into service some equipment when probably most of your staff is away for the holidays. It has a traumatic impact.

At that point in the process, the way I would say it is rather than you proactively managing or motivating someone to behave, all you are doing is just sophistically scorekeeping. At that point it is just, well, what did I actually do? And did I take advantage of what was there now that it has happened? As opposed to January 1, knowing with assurance what you can rely upon.

Mrs. CHU. And finally, Congress has created tax incentives to encourage business investment, but some tax experts have pointed that one-time tax breaks create complexity. Do you think there are times when there should be exceptions made for temporary targeted incentives?

Mr. LEWIS. Well, I will say historically you are correct, that you have had times where there have been one-time off incentives. But I would go back to what I talked about with the good tax policy.

There are various elements that you have to balance. One is you want neutrality. You want to have it be neutral and not necessarily motivate one way or the other. You want it to be simple. You want it to be certain, easy to administer, equity, and fairness. It can be in some payment.

So the answer to your question is you have got to consider all those in any one particular situation. And it would just depend. There is no perfect tax law. If you just listen to that list I just gave you, you will observe that there is this tradeoff. Right? And so at some point it might make sense to embrace one or the other because you are going to have to do that, but, again, it would be a fact-specific situation.

Chairman CHABOT. The gentlelady's time has expired.

The gentlelady from Florida, Ms. Murphy, who is the ranking member of the Subcommittee on Contracting the Workforce, is recognized for 5 minutes.

Ms. MURPHY. Thank you all for being here. I represent a district in Central Florida where small businesses are a significant part of the economy. But the district is also the youngest district in Florida, being home to the University of Central Florida, which is the second largest university in the country. And the millennial generation and the younger generation, there are studies that are showing that they are engaged in the gig economy more significantly and that that is going to grow significantly over the next 10, 20 years.

And as such, they are considered to be self-employed. With the Social Security and Medicare taxes, they are generally paid as a part of a combined rate of 15.3 percent, half paid by the employer, the other half paid by the employee.

In the case of self-employed individuals, they paid both, as if they are both the employer and the employee.

So I guess my question for you is that would you consider this an inequity to sole proprietorships? And then more broadly, what kinds of changes do you think are necessary in the Tax Code to support this growing gig economy, the growing prevalence of self-employed individuals?

Mr. BURTON. Well, let me just jump in real quick because I address that subject in my written testimony, and it is a problem that has been lingering since the 1970s that really needs to get fixed. There is a great deal of uncertainty about classification issues and whether someone should be treated as an independent contractor or an employee. And the IRS basically addresses this with a 20-factor test, and any test that has 20 factors is necessarily going to be arbitrary and uncertain because there is no real way to know how the IRS is going to weight the various factors.

And so what I have proposed in principle is to have bright-line tests for who is an employee, bright-line tests for who is not an employee, i.e., is an independent contractor, and in the middle ground allow either the employer or potentially the employee to elect subject to backup withholding probably at a 25 percent rate.

As to your other question about is it an inequity that self-employed people have to pay both the employer and employee share, the answer to that I think is no. The clear point is that there is a wedge imposed by the Social Security payroll taxes or Medicare

or any other tax between what the employer has to pay tax inclusive and what the employee gets after taxes. And that wedge should be the same whether you are an employee or whether you are self-employed. And that is what the self-employment tax does.

Mr. LEWIS. I can tell you from a practical standpoint that when I teach a group of students about the self-employment tax, particularly most of them being in this economy that you mentioned, it comes as a—I think the word is shock because typically I am teaching them in the winter and they are recognizing that they have got a whole lot of reckoning from the summer prior that they have not necessarily thought about. So maybe part of it is an educational process if nothing else, but the first time that they get hit with this it is an eye-opener. And if you are in the UCF community, you are going to see this a lot.

In terms of the equity of it, I think the Congress is going to have to deal with the fact that the tax base is moving. Right? The fact that we are so global and that you have got this economic shift between traditional going to work for the plant and manufacturing to this. Everyone is sort of self-employed, whether it be the driver for hires or the rentals that people have. We are just shifting to where people are more in tune with their own financial circumstances. You are going to have to address that somehow in the tax law and recognize that that is a big portion that is going to continue to grow.

Mr. BURTON. I once got asked who is FICA when they saw their first paycheck.

Ms. MURPHY. Thank you. And I yield back the rest of my time.

Chairman CHABOT. FICA is a very important part of our life, is he not? Or she? Thank you very much. The gentlelady yields back.

Our last questioner, I believe, will be the gentleman from Illinois, who was at the markup that I otherwise would have been at if I was not here because we are both on Judiciary, who is the ranking member on the Subcommittee on Agriculture, Energy, and Trade, Mr. Schneider.

Mr. SCHNEIDER. Thank you, Mr. Chairman.

Let me take personal prerogative. I am excited to be back on the Small Business Committee and working with you to make sure that we are helping what is the engine of our economy: small businesses that need to have the confidence and see the path to grow and prosper. So thank you very much.

The first question, just a quick question for Mr. Pomerleau, you talked about the issue of capital losses being offset against capital gains. And my understanding is the reason that is, is because capital gains are treated at a different tax rate than ordinary income. And so just real briefly, how would you adapt that as you are recommending to allow unlimited capital losses be offset against income?

Mr. POMERLEAU. Yeah. So I do not necessarily believe you need to offset on an unlimited basis, and one of the challenges here is that when you have run out of capital gains, the only thing left is say labor income, and that labor income is being taxed at a higher marginal tax rate than your capital gains. So if you get to deduct against that, you are actually receiving a larger benefit than

you should. So I think it has to be done in the context of a larger reform that rethinks how income is taxed. Because one of the challenges with having special tax rates on special types of income, whether it is passthrough income versus wage income or wage income versus capital income, is you run into these little administrative snags. So I think it would have to be done in the context of a larger—

Mr. SCHNEIDER. I think that emphasizes the point all the witnesses made. Thank you for being here, first of all, because I know how busy you are, but the idea that any type of tax reform we do has to not just be corporate tax reform, but include passthroughs and individuals.

Mr. Lewis, I am going to turn to you for as second, and you may have anticipated this question. I want to talk about cash accounting. And you talk about the importance of cash accounting for small business and entrepreneurs. But there are a whole group of businesses that are not typically considered entrepreneurial; for example, dentists and lawyers. Can you touch on who cash accounting affects besides the typical entrepreneurial startup business?

Mr. LEWIS. Yeah. Cash accounting is critical to small business. One group of businesses where cash accounting is sort of mitigated is those that where inventory is a significant portion of what they are doing. So the idea is if you are buying a lot of stuff for resale, that is kind of a little different circumstance. But most of these startup businesses at some level will be entitled to use cash.

But here is the key point. At some point, arbitrarily we set a deadline and say, okay, once you get beyond this point, now you need to move into accrual. And whether you set that limit at 10 million or at 25 million or some other limit perhaps, you need to recognize that that is going to have implications.

Specifically with respect to pass-through entities, such as CPA firms, because the profits are passed through to the owners' individual tax returns a threshold at any level would directly impact an owner's individual tax return because that owner would be required to pay tax on income he or she has not been paid for by the client.

I mean, we are in a country where we want to say to somebody, you know, within reason, grow your business. That is what creates jobs. That is what creates opportunities for other people. And so whether it is the capital aspect we have been talking about or whether it is freeing them up through the Tax Code, but that is why I was so emphatic saying that we have got to keep the cash method of accounting. And perhaps even look at expanding it because to your point that at some level an arbitrary ceiling will restrict growth, whether that is through merger or organic growth. But at some point, if I know as an entrepreneur that once I get beyond a certain point I am disincentivized because now I am going to add complexity and add all the cost, I am not going to be that interested.

Mr. SCHNEIDER. Thank you. I do not know if any of the other witnesses want to touch on that?

Mr. BURTON. Well, I agree it is very important, particularly for small firms. The principle underlying the Better Way plan is it is a cash flow tax, so it should address most of these issues when it

is fully flushed out. I would hope it would do it both in terms of the general accounting method, also inventory and so on. It is a huge simplification to premise your tax accounting on cash rather than accrual.

Mr. SCHNEIDER. So I will close with this and, Mr. Reynolds, it touches on something you talked about with your audits of having to explain to the IRS how your business works. Small businesses are different, but they are the engine. They are oftentimes family-owned businesses with multiple family members and they are pillars within the community. The time you take to come here to advocate on behalf of small business, to educate so many members of Congress, I cannot emphasize how important that is. The message has to be heard by our colleagues that we need to help small businesses have the confidence to step forward, to step up, and ultimately succeed to give us the growth we need. And with that I will yield back my time.

Chairman CHABOT. Thank you. The gentleman yields back.

And we want to thank the panel here for I think wonderful testimony here this morning and now this afternoon. I think the questions were great and we are obviously in the middle of tax reform, and we hope this is going to be a bipartisan process as much as possible. And as my colleague likes to say, there is no such thing as a Republican small business or a Democratic small business. They are just small businesses, and I think you all are getting the short end of the stick when it comes to the Tax Code right now.

So hopefully, some of the reforms that we are able to implement will positively affect small business entrepreneurship and, therefore, job growth all over America. So thank you for playing a very important role in that here this morning.

I would ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record.

Without objection, so ordered.

And if there is no further business to come before the Committee, we are adjourned. Thank you.

[Whereupon, at 12:36 p.m., the Committee was adjourned.]

APPENDIX



Written Testimony
Of
Kyle Pomerleau
Director of Federal Projects
Tax Foundation

Before the Committee on Small Business

“The Tax Code as a Barrier to Entrepreneurship”

Thank you Chairman Chabot and Ranking Member Velazquez for the opportunity to speak about the U.S. federal tax system and entrepreneurship.

There are millions of entrepreneurs in the United States, spread across nearly every major industry.¹ While every entrepreneur has a different business model and unique concerns, there are a few key characteristics that apply to many entrepreneurs throughout the economy:

Entrepreneurs tend to run losses for some time before turning a profit, and many entrepreneurial ventures do not survive long enough to turn a profit at all.²

As a result, entrepreneurial ventures tend to be especially risky investments for outside investors, who typically see many of their investments in entrepreneurs fail.³

If they do develop a successful business model, entrepreneurs often seek to rapidly expand their operations and scale.⁴

Ideally, the U.S. federal tax code would be neutral with regard to each of these characteristics. The tax code should not punish businesses for running sizeable losses in their early years, nor should it disadvantage investors that pursue risky investments. Certainly, it should not present additional barriers to successful businesses looking to expand.

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1 Bureau of Labor Statistics, “Business Employment Dynamics,” <https://www.bls.gov/bdm/#data>

2 Bureau of Labor Statistics, “Entrepreneurship and the U.S. Economy,” April 2016, https://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm

3 Seth Levine, “Venture Outcomes are Even More Skewed Than You Think,” August 2014, <http://www.sethlevine.com/archives/2014/08/venture-outcomes-are-even-more-skewed-than-you-think.html>

4 Neil Churchill and Virginia L. Lewis, “The Five Stages of Small Business Growth,” Harvard Business Review, <https://hbr.org/1983/05/the-five-stages-of-small-business-growth>

However, this is not the case under current U.S. tax law. The federal tax code penalizes businesses with large, up-front losses; discourages investors from pursuing risky opportunities; and makes it difficult for successful companies to expand. All of these features of the U.S. tax code create disadvantages for new businesses and entrepreneurs.

Lawmakers interested in improving the tax treatment of U.S. entrepreneurs would do well to consider ways to mitigate these three distortionary features of the current U.S. tax code.⁵

1. The Tax Treatment of Business Losses

It is often the case that entrepreneurs run losses for several years before turning a profit. However, the current federal tax code is particularly detrimental to businesses whose earnings fall into this pattern, and imposes a larger tax burden on businesses that take longer to turn a profit.

The reason for this is the fundamental asymmetry in the U.S. tax code between the tax treatment of business profits and business losses. A business that makes a profit is subject to an immediate tax liability, in the same year the profit is earned. However, a business that turns a loss is not always entitled to an immediate tax benefit.

If a business has a net operating loss in a given tax year, but has made a profit in previous tax years, the business is often eligible to "carry back" a net operating loss deduction to its previous years' tax returns – a provision which does allow the business to receive an immediate tax benefit. However, if the business's losses exceed its recent profits, then it is required to "carry over" the net operating loss deduction to a future tax year – meaning that the business does not receive an immediate tax benefit.⁶

Importantly, the longer a business has to wait to deduct its net operating losses, the smaller a tax benefit the business receives. A business that has a \$1 million loss in its first year of operation, and does not turn a profit until its tenth year of existence will not be able to deduct its \$1 million loss until the tenth year. By that time, the tax benefit from \$1 million deduction will be worth significantly less to the business, due to inflation and the time value of money.

As a result, the U.S. tax code is inherently disadvantageous to businesses that run losses for many years before turning a profit. As soon as these businesses become profitable, they are subject to an immediate tax liability – even though they did not receive an immediate tax benefit for all of the losses they incurred. Furthermore, if a company fails before it can ever turn a profit, then it will never receive a tax benefit for the losses it incurred, even though it would have been subject to a tax liability if it were profitable.

⁵ However, it should be noted that entrepreneurs do not necessarily receive worse tax treatment overall than other U.S. businesses. This is, in part, because the federal tax code also contains provisions that provide benefits specifically to entrepreneurs and small businesses, some of which are detailed below.

⁶ 26 U.S.C. §172. It should be noted that, in the case of pass-through businesses, owners are often able to deduct the net operating loss from one business against other personal income.

To summarize, the longer it takes for a business to turn a profit, the greater the tax penalty for that business. This is a feature of the U.S. tax code that is likely very disadvantageous for many entrepreneurs.

It is worth noting that the recently released House GOP “Better Way” tax plan would somewhat mitigate this issue by allowing businesses to increase their carried-forward net operating loss deduction by a factor reflecting inflation and the real return to capital.⁷ This measure should, in theory, make the net operating loss deduction equally beneficial to businesses whether claimed immediately or claimed far in the future. However, it would not provide any relief for companies that go out of business before they ever turn a profit.⁸

2. The Tax Treatment of Capital Losses

Entrepreneurs often rely on outside investors to provide financial capital for their businesses. Investments in entrepreneurial ventures tend to be risky, and investors may experience a long string of capital losses before finding an investment that produces a substantial capital gain. However, under the current tax code, these capital losses are not always immediately deductible, creating a situation that penalizes risky investment.

In general, taxpayers are only allowed to deduct their capital losses in any given year to the extent of their total capital gains in that year; individual taxpayers are also allowed to deduct up to \$3,000 in capital losses beyond this limitation (\$1,500 for married individuals filing separately). Otherwise, taxpayers are often required to “carry forward” all other capital losses to future tax years, when they can be deducted against future capital gains. In the case of corporations, capital losses can also generally be “carried back” up to three years.⁹

Here again, the tax code contains a fundamental asymmetry: capital gains are subject to an immediate tax liability, while capital losses do not necessarily yield an immediate tax benefit. To the extent that taxpayers are required to carry their capital losses forward many years before they are able to deduct them, the tax benefit of these losses diminishes each year that they are carried forward.

As a result, the U.S. tax code penalizes some taxpayers that make risky investments, by denying them a full, immediate deduction for their capital losses.¹⁰ This feature of the tax code makes it less advantageous to invest in entrepreneurial ventures.

⁷ “A Better Way: Tax,” June 2016, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

⁸ It is difficult to design a measure that would provide businesses with an immediate tax benefit for losses incurred, due to concerns that such a provision would create opportunities for gaming and tax shelters.

⁹ 26 U.S.C. §1211, §1212

¹⁰ Here, again, there is an administrative rationale for this feature of the tax code, which closes off opportunities for gaming of the tax system.

That said, that the tax code does allow households to deduct up to \$100,000 of capital losses on certain “small business stock” immediately against their ordinary income (\$50,000 for non-joint filers). This provision provides an incentive for taxpayers to invest in risky small business ventures.¹¹

3. The Tax Treatment of Business Investment

Entrepreneurs that develop a successful business model are often interested in scaling their operations as rapidly as possible. This expansion phase typically requires a great deal of capital investment, such as the purchase of equipment, buildings, and factories. However, the current U.S. tax code is especially burdensome on businesses that undertake significant capital investments, due to the current system of tax depreciation.

Under the current U.S. tax code, businesses are generally not allowed to deduct the full cost of their capital investments in the year that they are made. Instead, businesses are required to deduct their investment cost over long periods of time, according to a set of over two dozen depreciation schedules.¹² This system is quite complicated: the federal government estimates that businesses spend about 448 million hours each year complying with depreciation and amortization rules.¹³

According to standard economic theory, the federal tax depreciation system is an important determinant of the overall level of U.S. business investment. Because businesses value immediate deductions more than deductions in the future, the longer a business has to wait to write off the full cost of its capital expenses, the less likely the business is to undertake a new investment. In fact, there is evidence that small and cash-strapped businesses, such as startups, are particularly responsive to changes in depreciation schedules: in a recent paper, Eric Zwick and James Mahon show that small firms responded 95 percent more to the introduction of bonus depreciation than large firms.¹⁴

In fact, the tax treatment of capital investment has the highest stakes for entrepreneurs, who often spend a significant portion of their profits on the capital investments needed to establish and grow their operations. It is new and expanding businesses that stand to gain or lose the most from changes to the tax treatment of capital investment.

¹¹ 26 U.S.C. §1244

¹² 26 U.S.C. §167

¹³ Scott A. Hodge, “The Compliance Cost of IRS Regulations,” Tax Foundation, June 2016, <https://taxfoundation.org/compliance-costs-irs-regulations/>

¹⁴ Eric Zwick and James Mahon, “Tax Policy and Heterogenous Investment Behavior,” American Economic Review 107: 217-248, <http://www.ericzwick.com/stimulus/stimulus.pdf>

For the smallest businesses, the tax treatment of capital investment is generally favorable, due to section 179 of the tax code, which provides full expensing for many investments of small businesses. However, the rules for deducting capital investments can become much more burdensome for startup businesses in the "expansion phase," during which new businesses try to scale their model to new markets and broaden their offerings. During this phase in a business's lifecycle, the lengthy depreciation schedules of the tax code can serve as a barrier to investment, inducing businesses to pass up otherwise profitable investment opportunities due to tax considerations.

As a result, there is strong reason to believe that moving toward full expensing would encourage more entrepreneurial investment and remove barriers to the growth of startups. Notably, the House GOP "Better Way" plan would do just this, allowing both small and large businesses to deduct the full cost of their capital investments immediately.

4. High Tax Rates on Business Income

All three of these distortions in the U.S. tax code are exacerbated by the high marginal tax rates on businesses in the United States today. In general, if a business faces a high marginal tax rate on its profits, it will also be subject to a higher tax penalty for running losses for many years, and the depreciation system will pose a larger barrier to its new investment. Similarly, the higher the tax rate on capital gains, the greater the tax disadvantage will be for pursuing risky investments.

As such, it is important to note that income earned by U.S. entrepreneurs is generally subject to higher marginal tax rates today than in recent years past.

Entrepreneurs that choose to set up pass-through businesses, such as S corporations or partnerships, face a higher top federal tax rate (44.6 percent) today than at any point since 1986. As a recent Tax Foundation report shows, the top tax rate on pass-through business income can exceed 50 percent when state and local income taxes are taken into account.¹⁵

Other entrepreneurs choose to organize their businesses as C corporations. These businesses can be subject to taxation on both the entity level and the business level. The corporate income tax, on profits earned at the entity level, is levied at a 35 percent rate, the highest in the developed world.¹⁶ Meanwhile, the top tax rate on capital gains (25.0 percent) is the highest since 1997, while the top tax rate on dividends (25.0 percent) is the highest since 2002.

¹⁵ Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, January 2017, <https://taxfoundation.org/pass-through-businesses-data-and-policy/>

¹⁶ Kyle Pomerleau and Emily Potosky, "Corporate Tax Rates Around the World, 2016," Tax Foundation, August 2016, <https://taxfoundation.org/corporate-income-tax-rates-around-world-2016/>

It should be noted, however, that for some entrepreneurs and investors, the high tax rates on capital gains can be mitigated by the favorable tax treatment of qualified small business stock. Since 2010, entrepreneurs and investors who hold “qualified small business stock” for more than five years are granted a 100 percent exclusion on the capital gains from their shares. This provision was made a permanent part of the tax code in 2015.¹⁷

Conclusion

As this testimony has shown, the U.S. tax code tends to impose higher burdens on businesses that run losses for many years, businesses that are risky investments, and businesses undergoing rapid expansion – all of which are typical characteristics of entrepreneurial ventures.

Lawmakers interested in removing these barriers to entrepreneurship should consider ways to mitigate these three distortions in the U.S. tax code: the limited deductibility of business net operating losses, the limited deductibility of capital losses, and lengthy depreciation schedules.

¹⁷ 26 U.S.C. §1202



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CONGRESSIONAL TESTIMONY

“The Tax Code as a Barrier to Entrepreneurship”

Testimony before

The Committee on Small Business
United States House of Representatives

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My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Chairman Chabot, Ranking Member Velázquez, and members of the committee for the opportunity to be here this morning. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Entrepreneurship matters. It fosters discovery, innovation and job creation. It leads to more productive production processes that improve productivity and real wages. Entrepreneurs develop new and less expensive products that improve consumer well-being. They make markets more efficient. New firms account for most of the net job creation in the United States. Moreover, the vast majority of economic gains from innovation and entrepreneurship accrue to the public at large, rather than entrepreneurs.

Entrepreneurship is in decline. The rate of new business formation has seriously declined and barely exceeds business exits. Many other indicia of entrepreneurial health also indicate that the United States has placed an unprecedented burden on small and start-up businesses. Accordingly, job creation, productivity improvements and welfare-enhancing innovation have slowed.

Although there are many reasons that entrepreneurs are struggling, the tax system is a major contributing factor. This is both because of the direct impact of the tax system on small and start-up firms and because of its adverse impact on the economy overall. The current tax system reduces the incentives to work, save and invest. It raises the cost of capital and reduces access to capital. It imposes high taxes on risk taking, harms the international competitiveness of U.S. businesses and impedes economic growth. Moreover, the tax system is monstrously complex, imposing inordinately high compliance costs on small and start-up firms.

Entrepreneurship Matters

Entrepreneurship matters.¹ It fosters discovery and innovation.² Entrepreneurs also engage in the creative destruction of existing technologies, economic institutions and business production or management techniques by replacing them with new and better ones.³ Entrepreneurs bear a high degree of uncertainty and are the source of much of the

¹ For an introduction to the literature, see Paul Westhead and Mike Wright, *Entrepreneurship: A Very Short Introduction* (Oxford University Press: 2013).

² Israel M. Kirzner, *Competition and Entrepreneurship* (University Of Chicago Press: 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (Routledge: 2006); William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton University Press: 2010).

³ See, e.g., Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1942), pp. 81-86 <http://digamo.free.fr/capisoc.pdf>; W. Michael Cox and Richard Alm, "Creative Destruction," *Concise Encyclopedia of Economics* (Liberty Fund: 2007) <http://www.econlib.org/library/Enc/CreativeDestruction.html>; Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Liberty Fund: 1996).

dynamism in our economy.⁴ New, start-up businesses account for most of the net job creation in the economy.⁵ Entrepreneurs innovate, providing consumers with new or better products. They provide other businesses with innovative, lower cost production methods and are, therefore, one of the key factors in productivity improvement and real income growth.⁶ In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital.⁷ The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large, rather than entrepreneurs.⁸ Entrepreneurs are central to the dynamism, creativity and flexibility that enables market economies to consistently grow, adapt successfully to changing circumstances and create sustained prosperity.⁹

Entrepreneurship is in Decline

Entrepreneurship is in decline. As the chart below illustrates, the business entry (or formation) rate has been steadily declining since 1977 but the business entry rate dropped very steeply in 2008 and has barely recovered.¹⁰ While the business entry rate now exceeds the business exit rate, by historical standards the net business formation rate is very anemic.

⁴ Frank H. Knight, *Risk, Uncertainty, and Profit* (1921)

<http://www.econlib.org/library/Knight/knRUP.html>.

⁵ Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938; Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24

<http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3>; Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation Issue Brief #3891, April 4, 2013

<http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses>.

⁶ Ralph Landau, "Technology and Capital Formation," in *Technology and Capital Formation*, Dale W. Jorgenson and Ralph Landau, editors (MIT Press, 1989).

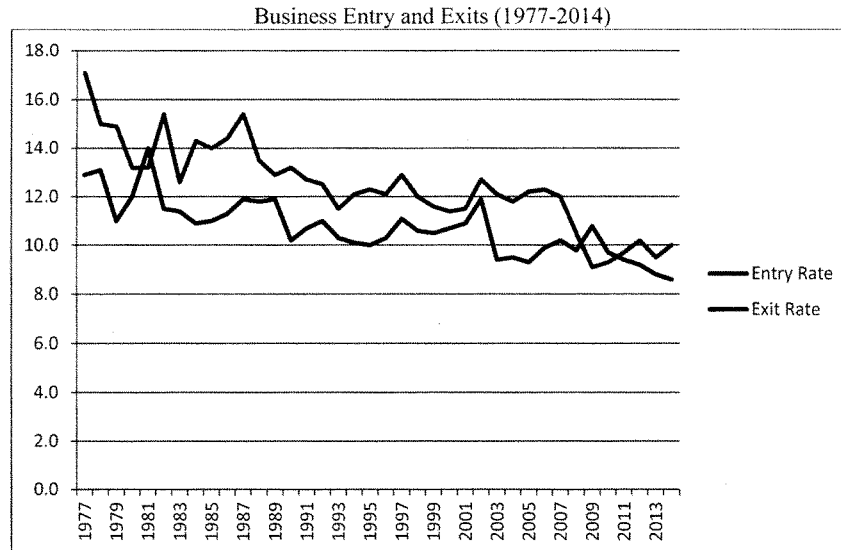
⁷ See, e.g., Robert M. Solow, *Growth Theory: An Exposition* (Oxford, 2000). Legal institutions, human capital and other factors are also important determinants of economic growth. See N. Gregory Mankiw, David Romer and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May, 1992), pp. 407–437

<http://www.fordham.edu/economics/mcleod/mankiw-romer-weil-a-contribution.pdf>; Robert J. Barro, *Economic Growth* (MIT Press: 2nd edition, 2003).

⁸ Yale economist William Nordhaus has estimated that 98 percent of the economic gains from innovation and entrepreneurship are received by persons other than the innovator. See William D. Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement," Cowles Foundation Discussion Paper No. 1457, April 2004 https://cowles.econ.yale.edu/P_cdn/d14b/d1457.pdf. Even if he is wrong by a factor of ten, this would still mean that 80 percent of the gains from entrepreneurship go to the public rather than the entrepreneur.

⁹ See, Decker *et al*, *supra*; C. Mirjam van Praag and Peter H. Versloot, "What is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Volume 29, Issue 4 (December 2007), pp 351–382 <http://link.springer.com/article/10.1007/s11187-007-9074-x>; G. R. Steele, "Laissez-faire and the Institutions of the Free Market," *Economic Affairs*, September 1999 <http://www.lancaster.ac.uk/staff/ecagrs/Laissez%20faire.pdf>.

¹⁰ Census Bureau, Business Dynamics Statistics, Establishment Characteristics Data Tables http://www2.census.gov/ces/bds/estab/bds_e_all_release.xlsx.



Source: Census Bureau, Business Dynamics Statistics, Establishment Characteristics Data Tables

The share of firms aged 16 years or more has increased by 50 percent over the last two decades.¹¹ High-Tech companies are shedding more jobs than they are creating.¹² Although recovering with the substantial increase in equity market values over the past several years and the regulatory improvements in the 2012 JOBS Act “IPO On-Ramp” provisions,¹³ Initial Public Offerings (IPOS) remain substantially below the previous two decades.¹⁴ Although there is improvement since the depths of the recession, small and start-up businesses continue to struggle.¹⁵ The decline in entrepreneurship is one of

¹¹ Ian Hathaway and Robert Litan, “The Other Aging of America: The Increasing Dominance of Older Firms,” Brookings Institution, July 2014
http://www.brookings.edu/~media/research/files/papers/2014-07-aging%20america%20increasing%20dominance%20older%20firms%20litan%20other_aging_america_dominance_older_firms_hathaway_litan.pdf; see also Decker *et al*, *supra*.

¹² John Haltiwanger, Ian Hathaway and Javier Miranda, “Declining Business Dynamism in the U.S. High-Technology Sector,” Kauffman Foundation, February 2014
<http://www.kauffman.org/~media/kauffman.org/research%20reports%20and%20covers/2014-02-declining-business-dynamism-in-us-high-tech-sector.pdf>.

¹³ Title I, The Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012
<http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf>.

¹⁴ David R. Burton, “Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth,” Heritage Foundation Backgrounder No. 2924, June 20, 2014
<http://www.heritage.org/research/reports/2014-06-reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth>.

¹⁵ Wendy Guillies, “Kauffman Foundation 2015 State of Entrepreneurship Address,” February 11, 2015
http://www.kauffman.org/~media/kauffman.org/resources/2015-02-2015_state_of_entrepreneurship_speech.pdf; John Dearie and Courtney Geduldig, *Where the Jobs Are: Entrepreneurship and the Soul of the American Economy* (Wiley: 2013); William C. Dunkelberg and Holly Wade, “NFIB Small Business Economic Trends,” August 2014 http://www.nfib.com/Portals/0/PDF/sbet_sbet201408.pdf.

the key factors causing anemic U.S. economic performance.

Helping to Restore Prosperity by Removing Impediments to Entrepreneurship

There are multiple reasons for the decline in entrepreneurial activity.¹⁶ The key to reversing the decline in entrepreneurship is to systematically reduce the legal impediments to entrepreneurship. There is not any one policy change – or even a few – that will lead to a sudden renaissance in entrepreneurship. Since the decline is caused by the combined weight of many poor public policies, the solution requires systematically improving public policy in a wide variety of areas. It is clear, however, that the tax system is a leading reason for the poor economic performance of recent years and that tax reform offers a means of substantially improving the economy, increasing wages and giving rise to a renaissance in entrepreneurship.

The remainder of my testimony examines the sources of complexity in the tax code and its economic effects more generally. It then discusses proposed improvements to the tax system. My discussion of proposed reforms is divided into two parts. The first section discusses reforms to the existing tax system that will aid entrepreneurship. The second section addresses more major or fundamental tax reform.

Sources of Complexity in the Tax Code

The compliance costs¹⁷ associated with the income tax have been estimated to be in the range of \$67 billion to \$410 billion.¹⁸ The higher estimate, which is quite plausible given its derivation, is 2.2 percent of Gross Domestic Product (GDP) and about 12 percent of federal receipts. These high compliance costs have a disproportionately adverse impact on small and start-up businesses. Compliance costs do not increase linearly with size.

Among the four largest sources of complexity in the tax law are (1) the capital cost recovery system; (2) inventory accounting; (3) employee benefit taxation, particularly the retirement savings (qualified account) rules; and (4) international taxation.

Under current law, there are generally five different capital cost recovery or depreciation systems with which businesses must contend. They are: (1) the Modified Accelerated

¹⁶ For an international survey of regulatory impediments to entrepreneurship and a literature survey, see *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises* (World Bank: 2013) <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports-English/DB14-Full-Report.pdf>; for a list of regulatory impediments to entrepreneurship in the United States and proposed reforms to address them, see David R. Burton, “Building an Opportunity Economy: The State of Small Business and Entrepreneurship,” Testimony before The Committee on Small Business, United States House of Representatives, March 4, 2015 http://smallbusiness.house.gov/uploadedfiles/3-4-2015_final_burton_testimony_final.pdf.

¹⁷ Compliance costs include legal, accounting and administrative costs but not lost economic output (i.e. the deadweight loss or excess burden of the tax system).

¹⁸ Scott A. Hodge, “The Compliance Costs of IRS Regulations,” Tax Foundation Fiscal Fact No. 512, June 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF512.pdf and Jason J. Fichtner and Jacob M. Feldman, “The Hidden Costs of Tax Compliance,” Mercatus Center, May 20, 2013, https://www.mercatus.org/system/files/Fichtner_TaxCompliance_v3.pdf.

Cost Recovery System (MACRS) using the General Depreciation System (GDS);¹⁹ (2) the Modified Accelerated Cost Recovery System (MACRS) using the Alternative Depreciation System (ADS);²⁰ (3) the depreciation rules under the alternative minimum tax (AMT);²¹ (4) the depreciation rules applicable for determining earnings and profits²² and (5) expensing.²³ As discussed below, for economic and administrative reasons, capital expenses should simply be deducted in the year incurred (i.e. expensed).

Inventory accounting also introduces a high degree of complexity.²⁴ The Internal Revenue Code section 263A uniform capitalization rules are especially complex. Firms with gross receipts under \$10 million annually are allowed to use less complex rules. But for any size firm that maintains inventory, these rules are a major burden.

The taxation of employee benefits is a major source of complexity. The tax treatment of qualified plans is absurdly complex. But the rules governing health insurance, FSAs, HSAs, tuition assistance, life and dental insurance and a host of other matters introduce complexity and costs.

And for firms that operate internationally, the income sourcing and expense allocation rules, the intercompany pricing rules, the foreign tax credit rules (especially the separate basket limitations), the controlled foreign corporation rules and subpart F, the export sourcing rule and many other provisions introduce a very high degree of complexity.

The incremental reforms outlined below address all of these sources of complexity except the international tax provisions. Major tax reform would address all of them.

Primary Impediments to Economic Growth in the Tax Code

The current U.S. tax system has a very substantial negative impact on the economy. It has high marginal tax rates that reduce the incentive to work, save and invest. The U.S., for example, has the highest corporate tax rate in the industrialized world. It substantially raises the cost of capital by double, treble or even quadruple taxing savings and investment. It places U.S. businesses at a competitive disadvantage in international markets. It is riddled with special tax preferences. And it imposes large compliance costs on U.S. businesses, which has a disproportionately negative impact on small firms.

The solution is to reduce marginal tax rates, particularly on businesses, to expense

¹⁹ Internal Revenue Service, "4. Figuring Depreciation Under MACRS," <https://www.irs.gov/publications/p946.ch04.html>.

²⁰ Ibid.

²¹ See "Instructions for Form 4626, Alternative Minimum Tax – Corporations," <https://www.irs.gov/pub/irs-pdf/i4626.pdf>. For shareholders, partners or members of pass-through entities, the individual AMT would apply.

²² 26 CFR 1.312-15. Earnings and profits is primarily used to determine if a corporate distribution is a taxable dividend or a return of capital.

²³ Internal Revenue Code §179 and various special expensing provisions.

²⁴ Accounting Periods and Methods, Inventories, IRS Publication 538 <https://www.irs.gov/pub/irs-pdf/p538.pdf>.

capital, to eliminate true tax preferences and to simplify the tax system.²⁵ Major tax reform along these lines can be expected to increase GDP by about 10 percent over 10 years. Truly fundamental tax reform would increase GDP by about 15 percent over 10 years.

Incremental Reforms to the Current Tax System

Incremental improvements to the current tax system that Congress should consider are outlined below.

1. *Expensing of Investment in Machinery and Equipment.* Amend Internal Revenue Code §179 to permanently allow annual capital expenses of up to \$1 million to be deducted when incurred. Expensing would simplify small firms' tax returns, reduce compliance costs, reduce small firms' cost of capital and aid cash flow.²⁶
2. *Retirement Account Simplification.* Very few small employers offer retirement accounts because of the complexity, high compliance costs and regulatory risk of doing so.²⁷ This makes it more difficult for them to attract employees and more difficult for both the small business owners and their employees to save for retirement. This is one of the most complex areas of the tax law and desperately in need of simplification.²⁸

One possible solution would be to amend the Internal Revenue Code to create a Small Business Uniform Retirement Account as a voluntary alternative for employers with 500 or fewer employees to replace: (1) simplified employee pensions (SEPs), (2) salary reduction simplified employee pensions, (3) SIMPLE IRA plans, (4) SIMPLE 401(k) plans, (5) Keogh plans, (6) regular 401(k)s (with respect to employers with 500 or fewer employees), (7) profit-sharing plans (with respect to employers with 500 or fewer employees), (8) money purchase pension plan (with respect to employers with 500 or fewer employees), and (9) employee stock ownership plans (with respect to employers with 500 or fewer employees). The Small Business Uniform Retirement Account would (1) have check the box

²⁵ For a more complete discussion, see David R. Burton, "A Guide to Tax Reform in the 115th Congress," Heritage Foundation Backgrounder No. 3192, February 10, 2017 <http://www.heritage.org/sites/default/files/2017-02/BG3192.pdf>.

²⁶ David Burton, "Constructive Small Business Expensing Bill Introduced," *The Daily Signal*, April 11, 2014 <http://dailysignal.com/2014/04/11/constructive-small-business-expensing-bill-introduced/>; Curtis Dubay, "Ways and Means Committee Following Right Approach on Tax Extenders," *The Daily Signal*, May 27, 2014 <http://dailysignal.com/2014/05/27/ways-means-committee-following-right-approach-tax-extendere/>.

²⁷ Kathryn Kobe, "Small Business Retirement Plan Availability and Worker Participation," Small Business Administration, Office of Advocacy, March 2010, Table 2 (only 28 percent of firms with under 100 employees offered some kind of retirement plan in 2006) <https://www.sba.gov/sites/default/files/rs361tot.pdf>.

²⁸ See generally, David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs and Account Simplification," Testimony before The Committee on Ways and Means, United States House of Representatives, April 17, 2012 <http://www.heritage.org/research/testimony/2012/04/pursuing-universal-retirement-security-through-automatic-iras-and-account-simplification>.

eligibility, (2) uniform employee eligibility, (3) automatic enrollment of employees with an option to opt-out, (4) no non-discrimination, coverage or key employee rules, (5) allow contribution levels to be chosen by the employee, (6) be maintained through a financial institution and (7) be available to employees and self-employed persons (including partners and LLC members).

3. *Reduce the Top Long-term Capital Gains Tax Rate to 20 percent or Less.* Evidence shows that a capital gains rate much above 20 percent actually reduces federal revenues. In addition, a high capital gains tax rate reduces the willingness of investors to invest in relatively risky start-up and growth companies and impedes capital formation. The top long-term capital gains tax rate should not exceed 20 percent (including the Obamacare investment income tax).²⁹
4. *Permit Cash Method Accounting for Firms with up to \$10 million in Gross Receipts.* Cash method accounting is simpler and aids cash flow.³⁰
5. *S Corporation Liberalization.* Permit S corporations to have more than one class of stock, non-resident alien shareholders (subject to 30 percent withholding on dividends) and more than 100 shareholders. The latter is particularly important if S corporations are going to have practical access to the crowdfunding or Regulation A+ provisions in the JOBS Act which allows companies to raise small amounts from a large number of investors using provision enacted by the JOBS Act.³¹ It is preferably for the S corporation rules to emulate the partnership rules so there would be no shareholder limit but S corporation status would not be available to publicly traded corporations. See Internal Revenue Code §7704.
6. *Repeal the Obamacare Health Insurance Tax.* Obamacare imposes an excise tax on health insurance premiums that effectively is aimed at small businesses because larger firms self-insure (with or without stop-loss insurance) and therefore do not pay health insurance premiums. It is roughly equivalent to a 2.5 percent tax. This tax should be repealed.³²

²⁹ J.D. Foster, "Obama's Capital Gains Tax Hike Unlikely to Increase Revenues," Heritage Foundation Backgrounder #2391, March 24, 2010 <http://www.heritage.org/research/reports/2010-03-obamas-capital-gains-tax-hike-unlikely-to-increase-revenues>; Stephen J. Entin, "President Obama's Capital Gains Tax Proposals: Bad for the Economy and the Budget," Tax Foundation January 21, 2015 <http://taxfoundation.org/blog/president-obama-s-capital-gains-tax-proposals-bad-economy-and-budget>.

³⁰ Then Ways and Means Committee Chairman Dave Camp proposed this in his Tax Reform Act of 2014 discussion draft. See section 3301 http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

³¹ Rep. French Hill introduced H.R. 4831 (114th Congress) which would disregard crowdfunding and Regulation A shareholders for purposes of the subchapter S shareholder limit count. See David Burton, "The Tax Law Makes It Almost Impossible for 'S Corporations' to Use Equity Crowdfunding," *Daily Signal*, April 19, 2016 <http://dailysignal.com/2016/04/19/the-tax-law-makes-it-almost-impossible-for-s-corporations-to-use-equity-crowdfunding/>.

³² David R. Burton, "Obamacare's Health Insurance Tax Targets Consumers and Small Businesses," Heritage Foundation Issue Brief #4075, October 31, 2013.

7. *Reduce the Tax Rate of Pass-Through Entity income to the Corporate Tax Rate.* Reduce the tax rate paid on income from S corporations and other pass-through entities (e.g. LLCs) to no more than the top corporate tax rate (currently 35 percent). Ideally, however, the tax rate on pass-through entity income and other income would be both low and the same. Otherwise, Congress must draft rules distinguishing between pass-through entity income, on the one hand, and labor and portfolio investment income on the other. Such rules will inevitably lead to complexity.
8. *Increase the Incentive Stock Option (ISO) Cap Limitation from \$100,000 to \$250,000.* Internal Revenue Code section 422(d) limits incentive stock options to \$100,000 in aggregate stock value (not gain). This limits the utility of ISOs as a means to attract talent.
9. *Full Deductibility for Health Insurance Purchased by the Self-Employed.* Currently, health insurance costs incurred by the self-employed (which includes partners and LLC members) are deductible for income tax purposes but not for purposes of the 15.3 percent self-employment tax. This creates a special tax burden on the self-employed not borne by anyone else in the economy. There should be parity for the self-employed with those who are employed. Internal Revenue Code §162(l)(4) should be repealed.
10. *Clarify Rules Governing to What Extent Distributions from Pass-Through Entities are Subject to Payroll Taxes.* This issue has existed since at least the 1980s and it has never been adequately resolved. It causes a lot of audits and a lot of uncertainty. Reasonable, clear and uniform rules governing “reasonable compensation” and investment income should be adopted for partnerships, S corporations and C corporations.
11. *Clarify Employee/Independent Contractor Rules.* This issue has existed since at least the 1970s and it has never been adequately resolved. Current law involves evaluating 20 factors and any test with 20 factors is inherently ambiguous and will be arbitrary in application.³³ The current state of the law causes a lot of audits and a lot of uncertainty. Provisions should be adopted providing bright line tests for determining who is definitely an employee and who is definitely a contractor and allowing the employer to choose whether a payee is an employee or a contractor in ambiguous cases, subject to 1099 reporting and moderate backup withholding if contractor status is elected.³⁴

<http://www.heritage.org/research/reports/2013/10/obamacare-s-health-insurance-tax-targets-consumers-and-small-businesses>.

³³ For general background see “Present Law and Background Relating to Worker Classification for Federal Tax Purposes,” Joint Committee on Taxation, [JCX-26-07] May 8, 2007 <http://www.jct.gov/x-26-07.pdf>. See also “Independent Contractor or Employee,” IRS Publication No. 1779 <https://www.irs.gov/pub/irs-pdf/p1779.pdf>; IRS Rev. Rul. 87-41 (1987); Treas. Reg. § 31.3121(d)-1 Who are employees.

³⁴ A withholding rate of 25 percent would reflect the 15.3 percent payroll tax plus an approximately 10 percent average income tax liability.

12. *Estate and Gift Tax Reduction.* The unified credit should be increased so that \$10 million is effectively excluded from the estate and gift tax. For 2017, the amount that is effectively excluded is \$5.5 million. Family farms and businesses should not either have to be sold to pay estate taxes when parents die or incur huge life insurance premiums to provide the means of paying the tax.³⁵ Ideally, of course, the estate and gift tax should be repealed entirely.

Major Tax Reform

Fundamental tax reform would reduce compliance costs considerably and result in dramatically higher rates of capital formation, economic growth and job creation. The goal of fundamental tax reform is a simple, flat rate, territorial consumption tax to replace the individual and corporate income tax and the estate and gift tax. This can take one of four forms. (1) A Hall-Rabushka-Army-Forbes flat tax, (2) A consumed income tax (also known as an expenditure tax, cash-flow tax, inflow-outflow tax or the new flat tax), (3) a national sales tax or (4) a Business Transfer Tax (BTT) (also known as a business flat tax, business consumption tax or business activity tax) or, potentially, some combination of these.³⁶ Major tax reform is a major step towards fundamental tax reform and would therefore reduce compliance costs considerably and result in higher rates of capital formation, economic growth and job creation.

Under the leadership of House Speaker Paul Ryan (R-WI) and House Ways and Means Committee Chairman Kevin Brady (R-TX), House Republicans released a blueprint for their tax reform initiative in June 2016.³⁷ Since that time, the Ways and Means Committee has been drafting legislation and working toward a consensus among Republicans on the committee. This plan is certainly major tax reform and would have a substantial positive impact on the economy and entrepreneurs.

³⁵ William W. Beach, "Seven Reasons Why Congress Should Repeal, Not Fix, the Death Tax," Heritage Foundation Web Memo #2688, November 9, 2009

<http://www.heritage.org/research/reports/2009/11/seven-reasons-why-congress-should-repeal-not-fix-the-death-tax>; John L. Ligon, Rachel Greszler and Patrick Tyrrell, "The Economic and Fiscal Effects of Eliminating the Federal Death Tax," Heritage Foundation Backgrounder #2956, September 23, 2014 <http://www.heritage.org/research/reports/2014/09/the-economic-and-fiscal-effects-of-eliminating-the-federal-death-tax>.

³⁶ David R. Burton, "Four Conservative Tax Plans with Equivalent Economic Results," Heritage Foundation Backgrounder No. 2978, December 15, 2014

<http://www.heritage.org/research/reports/2014/12/four-conservative-tax-plans-with-equivalent-economic-results>; David R. Burton, "A Guide to Tax Reform in the 115th Congress," Heritage Foundation Backgrounder No. 3192, February 10, 2017 <http://www.heritage.org/sites/default/files/2017-02/BG3192.pdf>.

³⁷ Paul Ryan and Kevin Brady, "A Better Way: Our Vision for a Confident America, Tax," June 24, 2016, <https://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

The Ryan–Brady “Better Way” blueprint would provide the lowest marginal tax rates since the 1920s, and expense machinery, equipment and structures. The top individual tax rate would be 33 percent (compared to 43.4 percent today); the top tax rate on C corporations would be 20 percent (compared to 35 percent today); and the top tax rate on pass-through businesses would be 25 percent (compared to 43.4 percent today). Many other changes would be made. It would have a dramatic positive economic impact. The Tax Foundation estimates it would increase GDP by 9.1 percent over 10 years, and reduce revenues by \$191 billion over 10 years.³⁸ The federal government is expected to raise \$43 trillion in tax revenue over the next 10 years.³⁹ Thus, the Brady plan is projected to reduce revenues by less than one-half of one percent.

This plan is most succinctly understood as a graduated rate version of the Hall–Rabushka flat tax.⁴⁰ The two primary differences between the Better Way plan and the traditional Hall–Rabushka flat tax are that the Better Way plan has a border-tax adjustment and, instead of taxing only wages at the individual level, it has an additional tax on dividends, interest, and capital gains at half the statutory rate. It is therefore a very large step toward the right tax base with much lower marginal tax rates than those of the current system.

It would aid small businesses for two reasons. First, it would result in a much stronger economy. Second, it would reduce the burden of the tax system on entrepreneurs. Corporate and pass-through tax rates would decline sharply. All capital and inventory acquisition expenses would be immediately deductible. Capital gains tax rates would fall to 16.5 percent or less, depending on the tax bracket. It would substantially simplify the tax system. Thus, small and start-up firms can expect to see their marginal tax rates decline and their cost of capital decline. They will incur lower compliance costs. And their investors will pay lower marginal tax rates as well.

Thank you.

³⁸Kyle Pomerleau, “Details and Analysis of the 2016 House Republican Tax Reform Plan,” Tax Foundation *Fiscal Fact* No. 516, July 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF516.pdf.

³⁹Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, Summary Table 1, CBO’s Baseline Budget Projections, p. 2, <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016outlook.pdf>.

⁴⁰Graduated rate versions of the Hall–Rabushka flat tax are often called an “X Tax” after David Bradford’s proposal. See David F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986). See also *Report of the President’s Advisory Panel on Federal Tax Reform*, 2005, <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

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Testimony of Tim Reynolds

President

Tribute, Inc.

On behalf of the National Small Business Association



House Small Business Committee

"Start-ups Stalled? The Tax Code as a Barrier to Entrepreneurship"

February 15, 2017

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Washington, DC 20005
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www.nsba.biz

Good Morning. Chairman Chabot, Ranking Member Velázquez and members of the House Small Business Committee, I want to thank you for inviting me to testify today on the biggest tax problems facing America's small businesses, and discuss ways the tax code operates as a barrier to business creation and growth.

My name is Tim Reynolds, owner and President of Tribute Inc., a software company located in Hudson, Ohio. Our 38 employee company develops and markets software for industrial distributors. The company focuses primarily on distributors of hydraulic and pneumatic equipment, specialty and industrial hose and rubber, and gasket products. By way of example, many customers are Eaton or Parker Hannifin distributors. Tribute develops and markets two Enterprise Resource Planning (ERP) products: the Tribute Software System, a UNIX-based solution, and TrulinX, a Windows-based solution. Both provide a fully integrated business system supporting virtually all of the distributors' business system needs.

I am pleased to be here representing not only my company, but also the National Small Business Association (NSBA), where I currently serve as an Honorary Trustees member and Past Chairman. NSBA is the nation's oldest small-business advocacy organization, with over 65,000 members representing every sector and industry of the U.S. economy. NSBA is a staunchly nonpartisan organization devoted solely to representing the interests of the small businesses which provide almost half of private sector jobs to the economy.

In recent years, there have been ambitious policy efforts in Congress to replace the current U.S. Tax Code. I welcome the eagerness of lawmakers to fix America's broken tax system, but I also recognize there are significant challenges with enacting comprehensive tax reform legislation in the near future. Therefore, in the interim, simplification of the most complex provisions of the Code may help to significantly reduce the burden on individual taxpayers and small businesses.

While there are many obvious problems with the current tax system, there are two paramount issues that must be addressed. The first major problem with the system is the generally high marginal rates of taxation on income. The other, oftentimes more significant dilemma is the almost impossible task of compliance with all the rules and regulations. It is time that Congress acts to reexamine the tax code and simplify or repeal some of its most complex provisions.

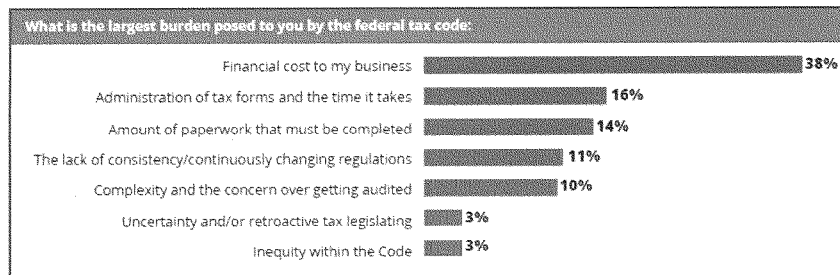
Compliance Costs

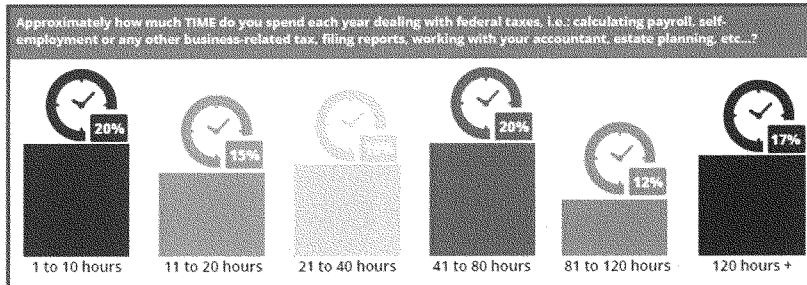
Although NSBA's members operate a wide variety of businesses, they all consistently rank tax simplification and reducing the tax burden among their top issues for Congress and the administration to address. The compliance burden on taxpayers, because of the complexity of our Code, is truly staggering. While the actual tax liabilities for small firms is a huge issue, the sheer

complexity of the tax code—along with the mountains of paperwork it necessitates—is actually a more significant problem for America's small businesses. For a small business, such as Tribute, Inc., the proportionate cost is significant, and the investment of time is even more consequential because it takes away from our productivity and growing the firm. Unlike larger corporations which have in-house accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal, small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government and Tax Code.

My company is a Subchapter S firm. As such, the income of my company flows to my personal tax return. I have an MBA from the University of Michigan, run a company that develops and sells accounting software and have been in business for more than 20 years. Yet, I would view it as taking an irresponsible risk to attempt to do my own tax returns. The Code is so complicated that I feel certain I would inadvertently run afoul of the law. So I have to pay an accounting firm to do these taxes. No doubt the CEO of a Fortune 500 company feels the same way. But as a small-business person, the cost of compliance is disproportionately large.

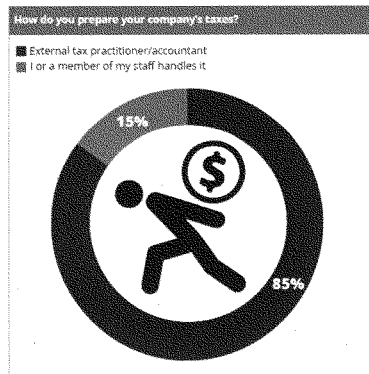
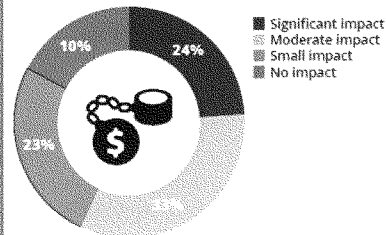
According to the NSBA 2016 Mid-Year Economic Report, federal taxes are a huge issue facing small business—and we have seen the administrative burden outpace the financial burden. This year is no different with 56 percent citing administrative burdens as their largest issue with federal taxes and 38 percent citing the actual financial cost.





Nearly half of small businesses spend more than 40 hours per year to comply with federal taxes, and nearly one-in-three spend more than 80 hours—two full work weeks each year. The majority of small businesses, 68 percent, spend more than \$1,000 per year on the administration alone of federal taxes. More than half say that federal taxes have a significant to moderate impact on the day-to-day operation of their business. Just imagine the collective business and job growth that could be done absent that burden. My company pays our accountants more than \$14,000 each year to

How much of an impact would you say federal taxes have on the day-to-day operation of your business?



prepare our

taxes. In addition, we spend about 40 hours a year preparing various forms and making various estimated payments required to comply with tax law.

More than half of NSBA members have fewer than five employees—few, if any of whom is a tax specialist—leaving business owners such as myself with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements. In fact, according to the NSBA 2015 Small Business Taxation Survey, only 15 percent of small-business owners handle their taxes internally—meaning 85 percent are

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forced to pay an external accountant or practitioner—this data should send a strong message to the IRS and Congress that the Tax Code is far too complex.

In addition to outside consultants, our company controller and bookkeeper spend significant time each week in the administration and filing of monthly and quarterly income and payroll reports, as well as trying to stay informed of changes to the Tax Code, changes to regulations, the status of current and expired tax extenders that may affect my business and so on. The aggregate cost of this represents thousands of dollars per employee and time away from doing more productive work to manage and grow my business.

According to a U.S. Small Business Administration (SBA) Office of Advocacy report entitled, “The Impact of Regulatory Costs on Small Firms,” the compliance costs incurred by businesses are estimated to be about \$95 billion annually but may be as much as 50 percent higher. Individual and not-for-profit compliance costs are, of course, quite substantial as well.

In the case of small businesses these costs include the time of small-business owners and their accounting staff devoted to collecting necessary information and filling out Internal Revenue Service (IRS) forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small-business compliance costs relative to income, revenues or per employee is disproportionately high. The SBA study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs is three times that of larger firms.

Tax Compliance Cost per Employee by Firm Size, According to SBA Office of Advocacy

	All Firms	Firms with <20 Employees	Firms with 20-499 Employees	Firms with 500+ Employees
Tax Compliance Cost per Employee	\$800	\$1,584	\$760	\$517

There will always be some compliance costs in any tax system. But today these costs are very high and if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent

growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

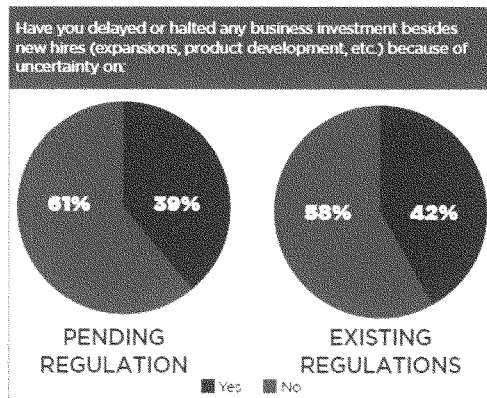
These costs also represent a significant drag on the economic growth, on job creation and on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress.

Regulatory Burdens

I firmly believe efforts to reduce the regulatory and administrative burdens on small businesses must focus on overall simplification, eliminating inequities within the Tax Code, and enhancing taxpayer education and outreach. A simpler tax code that is more easily understood by taxpayers would have many benefits, not the least of which would be reduced cost of compliance and reduced unintentional errors. Small businesses struggle to deal with the complexity of ambiguous terms, intricate technical language and difficult sentences. The increased burden causes us to have trouble understanding the requirements. This forces us to spend more time trying to interpret the rules and ensure we are completing the forms accurately thus avoiding being fined by the agency for noncompliance.

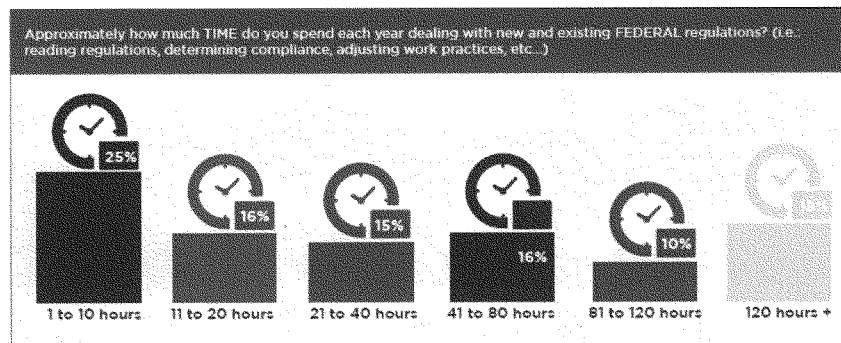
My company has been audited by the IRS twice. In both cases the eventual result was no errors found and therefore no penalties. In one case, the initial auditor did not understand the rules around deferring software sales revenue. After multiple appeals we finally were referred to her supervisor, who agreed with our interpretation of the deferral rules. My point is that in some cases even the IRS cannot easily interpret the rules! Yet, the cost of compliance falls on us.

The impact of regulatory burden cannot be overstated, according to the recently released 2017 NSBA Small Business Regulations Survey, more than one-third of small businesses have held off on business investment due to uncertainty on a pending regulation, and more than half have held off on hiring a new employee due to regulatory burdens.



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Furthermore, the average small-business owner is spending at least \$12,000 every year on regulations, and nearly one-in-three spends more than 80 hours each year dealing with federal regulation. We spend at least this much and more trying to understand and comply with IRS regulations, Department of Labor regulations as well as those of other agencies. Our biggest fear is that we don't know what we don't know! It is nearly impossible for us to keep up with new regulations and new rules.



It should come as no surprise, then, when NSBA asked what areas of regulations are most burdensome, the federal Tax Code and Affordable Care Act (ACA) were the top two. More specifically, three-in-four small firms say that federal Tax Code regulations are very or somewhat burdensome, and two-in-three say that the ACA regulations are somewhat or very burdensome. At Tribute, we have put tremendous effort into understanding and dealing with the ACA and ensuring that we offer a competitive and cost effective health care plan for our employees. Every single year we need to restart that effort because of the turbulence in the healthcare market place.

What makes regulatory compliance even more challenging for smaller firms, is that the small-business owner is the number one regulatory expert in most businesses and handles the bulk of federal regulatory compliance. My controller and I easily spend 10 hours each month ensuring that we stay in compliance with federal regulations. At the end of each quarter and at year-end the time spent nearly doubles as we scramble with filings.

Accurate tax reporting and compliance is extremely important to small business but vague rules and poorly defined regulations—often driven by vague, poorly defined and sunseting legislation—understandably result in mistakes. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts.

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Those willfully disregarding their tax liability should be held accountable. However, increased enforcement at the expense of taxpayer education will not in the long term accomplish sustained, improved compliance. The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. The fact that “complexity of rules” and “difficulty interpreting and understanding rules” combined to compose nearly half of all regulatory difficulties in NSBA’s regulations survey, is clear indication of the need for eased complexity, overall streamlining and adherence to plain language statutes.

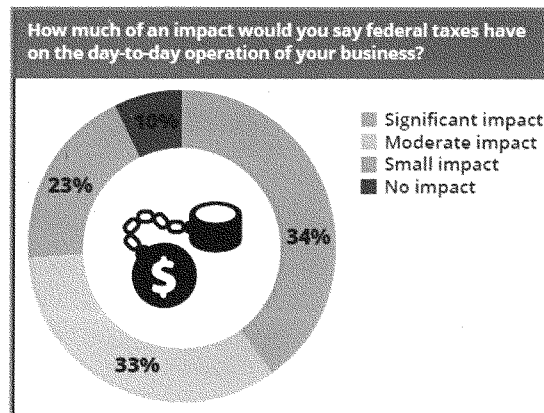
With the complexity facing many taxpayers, NSBA believes the development and implementation of initiatives to improve IRS guidance and assistance is important. The best thing for small businesses is simplicity: simplicity in instructions, in requirements, in consequences and an overall reduction in the size of the paperwork and the time necessary to complete the forms.

All Tax Credits are Not Created Equal

According to NSBA’s tax survey, the majority of small businesses, 67 percent, say that federal taxes have a significant to moderate impact on the day-to-day operation of their business and 59 percent say credits and deductions have a significant to moderate influence over their decisions about their company and employees.

The discussion of tax policy must not occur in a vacuum. NSBA is firmly committed to seeing the deficit reduced and, as such, we believe it is important to promote those tax credits that stand to offer the most benefit to the most people, both directly and indirectly.

While there are a number of tax deductions, credits and exclusions that are very beneficial to small-business growth and overall economic stimulation, some do little to promote economic growth. They may have other policy objectives and may or may not achieve those objectives, but they do not materially affect the incentives to work, to save or to invest. One in particular that,



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while good-intentioned, does not offer broad relief is the hiring tax credit whereby a firm would receive a credit for hiring a previously unemployed individual. Small firms are unlikely to hire a new person simply for that tax credit – those that are in a place to hire will likely do so regardless of a temporary, one-time credit, and they will look for the person best suited with the appropriate skills. Unfortunately, if that person is not among the long-term unemployed that will not likely be a factor in the employer's decision making process. Tax credits play no role in our decision to hire. The cost of a new hire must ultimately be covered by additional revenues or reduced overall costs over the long run. Tax credits are temporary, unreliable and, for us, irrelevant.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace. It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Not only do these kind of investment-spurring tax credits and deductions help the qualifying firm, it helps promote economic growth by encouraging firms to make investments and purchase equipment from other firms. These tax provisions are the epitome of stimulatory.

Disadvantage at Tribute, Inc.

As a software development company, Tribute spends a significant amount of time, money and resources each year on research and development. As such, we are entitled to take advantage of the Research and Experimentation (R&E) tax credit, which can produce significant tax savings to innovative companies such as mine. As most small innovators, we are always trying to improve what we do, be more competitive, reduce costs and increase market shares. However, because we are a sub chapter S corporation and the income of the business passes thru to my personal income taxes, I am often subject to the Alternative Minimum Tax (AMT). For years, this prevented my company from taking the R&E credit, or we were limited to such a small amount each year that our accounting firm did not take the time to calculate what the credit might be. In fact, the costs of calculating the credit usually would exceed the allowable credit. The R&E tax credit is meant to encourage additional research and development, yet I am penalized for the way I structured my business. Small businesses are often America's greatest innovators, and yet the complicated tax code steps on its own foot in this area.

There is an ironic twist to this story. In 2015, Congress passed and the president signed into law, the Protecting Americans from Tax Hikes (PATH) Act, which made over a third of the so-called “tax extenders” into permanent law. The R&E tax credit was among the nineteen of the tax provisions that were made permanent parts of the Tax Code. Since 1981, this credit has expired and been renewed 16 times, making it one of the most unstable parts of the Tax Code. In doing research for today’s hearing, I learned that the PATH Act contained a provision which allowed small businesses (under \$50 million in gross revenue over the prior three years) to offset the AMT with R&E tax credits! So, I immediately thought—great, problem solved, BUT quickly learned it was too good to be true. Unfortunately, Congress limited the offset to C corporations, and as noted earlier in my testimony, most small businesses, including Tribute, are Sub(s) corporations. So with good intentions, the PATH Act missed the target on this provision. As complicated as the tax code is, this is not surprising. Often small businesses suffer from both unintended consequences and unrealized intended consequences. Further proving we desperately need to simplify.

Taxation of Pass-through Entities

As I previously mentioned, most small businesses are sole proprietorships, subchapter S corporations—such as Tribute, Inc.—or limited liability companies. Most of the remainder are partnerships (either limited or general). There also are some business trusts. All of these businesses (83 percent, according to NSBA data) pay taxes on their business at the personal income level, or are so-called “pass-through” entities that are subject to individual tax rates – not corporate tax rates. For my company, the pass-through tax implications are a major driver in our tax strategy each year. It is no surprise then, that income taxes and payroll taxes were ranked the top two most burdensome taxes by small firms.

Please rank, in order of their ADMINISTRATIVE burden on you and your business, the following taxes. (1 is the most burdensome and 10 is the least burdensome)

1. Payroll taxes
2. Income taxes (I am a pass-through entity)
3. State and local tax compliance
4. Sales tax
5. Property taxes
6. Corporate taxes (I am a c-corp)
7. Alternative Minimum Tax
8. Capital gains taxes
9. Medicare surcharge under Affordable Care Act
10. Changes to deductibility of tangible property repairs
11. Estate tax
12. Excise taxes (i.e.: Medical Device Tax)
13. International taxes (I export)
14. Import taxes (I import)

Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies’ net income before compensating the owners’ is usually consumed by paying the owners’ salary. This salary is also subject to the individual tax rates as, of course, are any dividends paid by the corporation to its shareholders. Thus, even for small C corporations, individual tax rates are key.

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Broad reform of the entire tax code is necessary, not just for corporate entities. Many proposals have called for reducing the corporate tax rate while eliminating various business deductions and credits, which—if not examined more closely—sounds like a fine plan. However, many pass-through entities utilize these tax benefits that would be on the chopping block. So now I would be facing the same, high tax rate on my business income, but I could no longer take advantage of some important tax credits and/or deductions. The result is a tax increase on my firm while large corporations would be given a tax cut. Allowing the smallest businesses to pay a much higher tax on their business income than a multinational, multi-billion corporations undercuts any semblance of fairness.

I firmly believe that addressing just one piece of the puzzle—such as corporate tax reform—will only lead to even greater complexity and a massive tipping of the scales in favor of the nation's largest companies at the expense of small businesses.

Imposing higher tax rates on small firms will stymie any growth from what is widely recognized as the source of much of the economic growth and dynamism in the U.S. economy: small business. For the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. Since small businesses disproportionately contribute to job creation, raising individual marginal tax rates can be expected to have a disproportionate negative impact on job creation. It is this kind of shortsightedness that has made the IRS a major foe of small firms and why so many of us support broad tax reform.

If Congress overhauls the tax system by dramatically broadening the base—cutting the breaks that litter the tax code—and lowering ALL rates, we would see real economic growth and raise revenues.

Principles of Tax Reform

While NSBA supports the Fair Tax as a viable option for tax reform, NSBA understands the political landscape and need to move forward on broad reform, even if in a different iteration. As such, NSBA has developed nine principles as part of the NSBA Tax Reform Checklist to which any broad tax reform package ought to adhere. The nine principles are:

- ✓ Designed to tax only once
- ✓ Stable and predictable
- ✓ Visible to the taxpayer
- ✓ Simple in its administration and compliance
- ✓ Promote economic growth and fairness between large & small businesses

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- ✓ Use commonly understood finance/accounting concepts
- ✓ Grounded in reality-based revenue estimates
- ✓ Fair in its treatment of all citizens
- ✓ Transparent

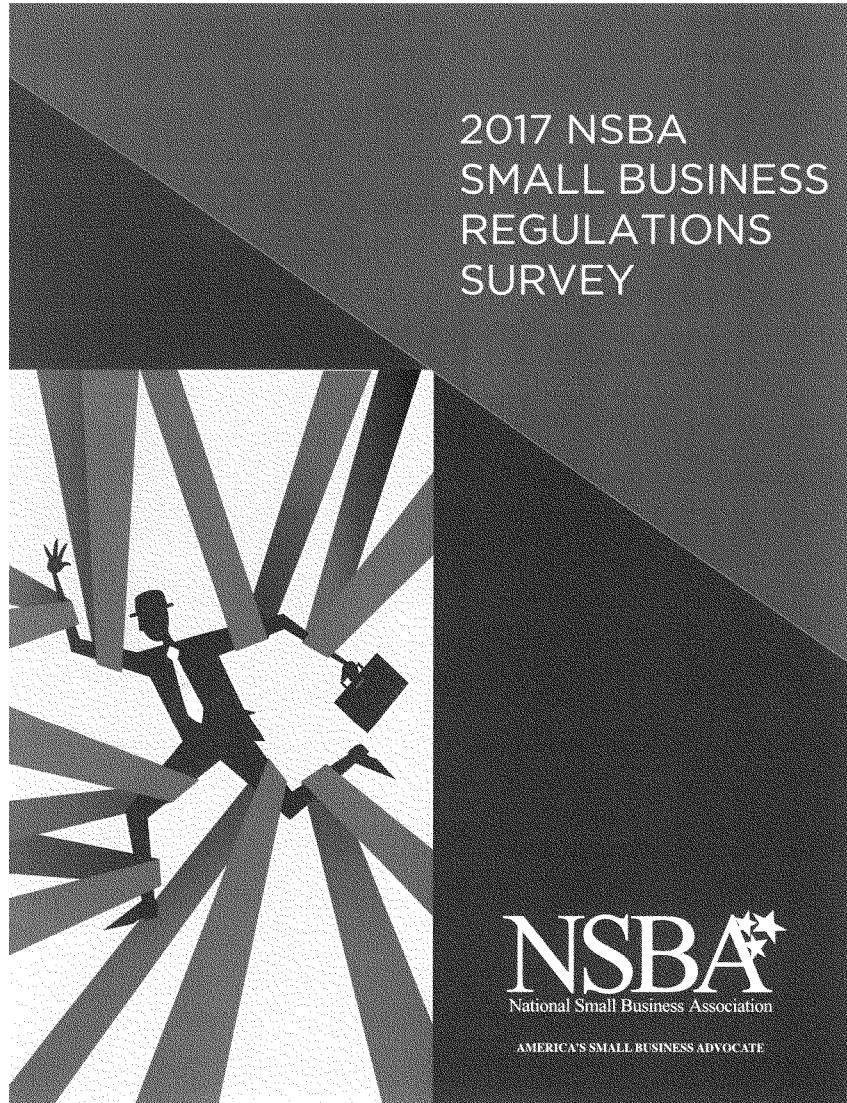
This kind of broad reform is what small firms want: according to NSBA's 2015 Small Business Taxation Survey, a large majority, 70 percent, expressed support broad reform of the tax system that reduces both corporate and individual tax rates, coupled with reducing both business and individual deductions.

Conclusion

Complexity and inconsistency within the tax code pose a significant and increasing problem for small businesses. The ever-growing patchwork of credits, deductions, tax hikes and sunset dates is a roller coaster ride without the slightest indication of what's around the next corner. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required. However, unless and until Congress agrees upon a replacement, we must fix tax problems with the current Tax Code by developing simplification measures that are fair and fiscally responsible.

Weighing in at more than 70,000 pages, the Tax Code punishes work, investment, risk-taking and entrepreneurship. The Tax Code is unfair to small businesses, biased against savings and investment, and impossibly complex. A tax system dedicated to investment, savings and small-business growth must be put in its place.

Again, I would like to thank Chairman Chabot and the members of the Small Business Committee for the opportunity to speak today. I would be happy to answer any questions you may have.



FOREWORD

The National Small Business Association (NSBA) is the nation's first small-business advocacy organization, celebrating 80 years of small-business representation in Washington, D.C. Focused on federal advocacy and operating on a staunchly nonpartisan basis, NSBA is a recognized leader of America's small-business community. Throughout the year, we conduct a series of surveys, including two Economic Reports and a series of issue-based surveys. Now, for the first time, NSBA has conducted a comprehensive survey on regulations and how they impact America's small businesses.

The 2017 NSBA Small Business Regulations Survey provides quantitative support for the need to greatly reduce regulatory complexity, streamline the web of federal, state and local regulations, and adhere to plain language statutes. Both the need for regulatory relief—as well as a road-map to achieve it—are laid out in this survey packet.

Among the most compelling data in the survey, we found that the average small-business owner is spending at least \$12,000 every year on regulations, and nearly one-in-three spends more than 80 hours each year dealing with federal regulation. We suspect these indicators would be much higher if the survey specified the inclusion in calculations of even long-standing regulations such as the 40-hour work week. It is highly likely that most small firms who took the survey simply considered such long-standing regulations a general cost of doing business rather than a regulatory burden, simply because they've dealt with them for so long.

No surprise, when asked what areas of regulation are most burdensome, the federal tax code and Affordable Care Act were the top two. We also found that the small-business owner is the number one regulatory expert in most business and handles the bulk of federal regulatory compliance. Astoundingly, 14 percent of small-business owners report they spend more than 20 hours per month on federal regulations.

Most small businesses say they really started worrying about regulations within the first year of their business. When coupled with the significant regulatory costs associated with a business' first year, it's clear that regulatory burden is a major hurdle likely keeping many would-be entrepreneurs from starting their own business.

The impact of regulatory burden cannot be overstated: more than one-third have held off on business investment due to uncertainty on a pending regulation, and more than half have held off on hiring a new employee due to regulatory burdens.

The 2017 NSBA Small Business Regulations Survey was conducted on-line Nov. 28, 2016 - Jan. 10, 2017 among 1,000 small-business owners. We hope you find this survey informative and useful. Please contact NSBA's media office for inquiries at press@nsba.biz.

Sincerely,



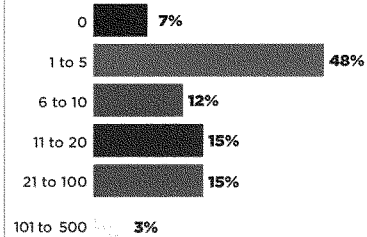
Pedro Alfonso
NSBA Chair



Todd McCracken
NSBA President and CEO

DEMOGRAPHICS

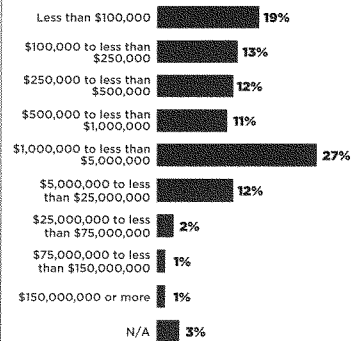
How many total full-time personnel are currently employed by your business?



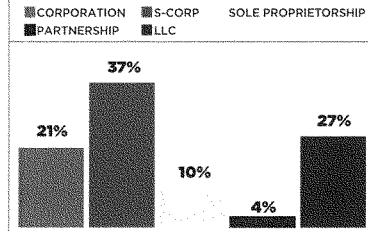
In what region is your business located?

New England	5%
Mid-Atlantic	20%
Great Lakes	15%
Farm Belt	7%
South	26%
Mountain	12%
Pacific	15%

What were your gross sales or revenues for your most recent fiscal year?



Which of the following best describes the structure of your business?



Which of the following best describes the industry or sector in which your business operates?

Professional	13%
Manufacturing	11%
Scientific and Technical Services	11%
Construction	10%
Agriculture, Forestry, Fishing and Hunting	8%
Other Services (except Public Administration)	8%
Information (IT)	6%
Retail Trade	5%
Health Care and Social Assistance	5%
Transportation and Warehousing	5%
Wholesale Trade	4%
Educational Services	4%
Real Estate, Rental and Leasing	3%
Accommodation and Food Services	2%
Finance	2%
Administrative and Support	1%
Arts, Entertainment, and Recreation	1%
Management of Companies and Enterprises	1%
Utilities	1%
Insurance	1%
Waste Management and Remediation Services	1%

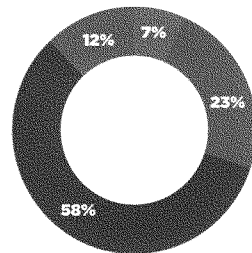
OVERALL REGULATORY BURDENS

It is critical to note that 12 percent of small-business owners say they don't even know the source of regulations impacting their business (local, state or federal)—a clear indicator that the web of local, state and federal regulations is massively confusing.

Nearly half of all small businesses said that regulations related to taxation and health care/health insurance are very burdensome.

Which source of regulation is most burdensome to your business?

☐ Local (city/county)
 ☐ State
 ☐ Federal
 ☐ I'm not sure what the source of regulations impacting my business is



Please rank each of the following areas in terms of the amount of total regulatory burden (including federal, state and local) your business incurs.

1	Tax-related
2	Health care and health insurance
3	Payroll & employee compensation
4	Industry-specific
5	Finance-related
6	Environment-related
7	Retirement/pensions
8	Workplace safety
9	Building-related

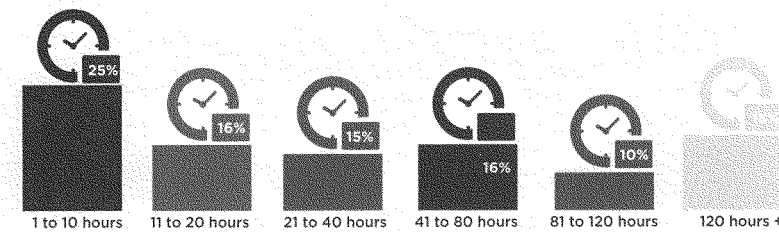
Three-in-four small firms say that federal tax code regulations are very or somewhat burdensome, and two-in-three say that the Affordable Care Act regulations are somewhat or very burdensome.

Please indicate how burdensome each of the following regulatory areas are, or would be if enacted, to your business.

Rank	Regulatory Areas	Very Burdensome	Somewhat Burdensome	Not Very Burdensome	No Impact	Not Sure
1	Federal Tax Code	38%	37%	12%	6%	7%
2	Affordable Care Act	43%	22%	11%	18%	5%
3	Overtime Rules	27%	24%	22%	22%	5%
4	State licensing Requirements	17%	28%	25%	19%	11%
5	Reporting Pay Data by Gender and Race	19%	21%	23%	26%	11%
6	Independent Contractor Test	14%	25%	26%	21%	14%
7	EPA Clean Water Rule	13%	11%	15%	45%	15%
8	Waters of the U.S. Rule	12%	9%	10%	48%	20%
9	Limit Carbon Emissions by Power Plants	8%	8%	10%	55%	19%
6	Fiduciary Rule for Investment Advisers	6%	11%	14%	47%	22%
7	Other	19%	4%	4%	34%	40%
8	Joint Employer Standards	7%	10%	17%	32%	34%

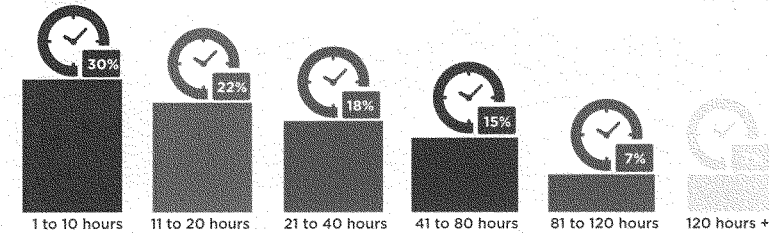
TIME SPENT ON REGULATIONS

Approximately how much TIME do you spend each year dealing with new and existing FEDERAL regulations? (i.e., reading regulations, determining compliance, adjusting work practices, etc...)



Forty-four percent of small firms report spending 40 hours or more each year dealing with new and existing FEDERAL regulations, and nearly one-in-three spend more than 80 hours each year.

Approximately how much TIME do you spend each year dealing with new and existing STATE and LOCAL regulations? (i.e., reading regulations, determining compliance, adjusting work practices, etc...)



When talking about STATE and LOCAL regulations, that number drops slightly to 30 percent who spend 40 hours or more each year.

MONEY SPENT ON REGULATIONS

Approximately how much MONEY in DIRECT costs do you spend each year dealing with new and existing FEDERAL regulations? (i.e., employee pay adjustments, workplace upgrades, daily work routine changes, attorney fees, etc...)

Less than \$500	21%
\$501 to \$1,000	11%
\$1,001 to \$5,000	19%
\$5,001 to \$10,000	19%
\$10,001 to \$20,000	12%
\$20,001 to \$40,000	8%
More than \$40,000	11%

Nearly half of small businesses report spending more than \$5,000 annually in DIRECT costs and another \$5,000 in INDIRECT costs to deal with FEDERAL regulations.

Approximately how much MONEY in INDIRECT costs do you spend each year dealing with new and existing FEDERAL regulations? (i.e., time taken away from other business tasks to understand regulations, meet with specialists, etc...)

Less than \$500	20%
\$501 to \$1,000	12%
\$1,001 to \$5,000	23%
\$5,001 to \$10,000	17%
\$10,001 to \$20,000	9%
\$20,001 to \$40,000	8%
More than \$40,000	10%

Approximately how much MONEY in DIRECT costs do you spend each year dealing with new and existing STATE and LOCAL regulations? (i.e., employee pay adjustments, workplace upgrades, daily work routine changes, attorney fees, etc...)

Less than \$500	26%
\$501 to \$1,000	18%
\$1,001 to \$5,000	24%
\$5,001 to \$10,000	16%
\$10,001 to \$20,000	8%
\$20,001 to \$40,000	4%
More than \$40,000	4%

Looking at the costs of regulations at the STATE and LOCAL level, more than half of small businesses report spending more than \$1,000 in DIRECT costs and another \$1,000 in INDIRECT costs.

Approximately how much MONEY in INDIRECT costs do you spend each year dealing with new and existing STATE and LOCAL regulations? (i.e., time taken away from other business tasks to understand regulations, meet with specialists, etc...)

Less than \$500	27%
\$501 to \$1,000	19%
\$1,001 to \$5,000	25%
\$5,001 to \$10,000	14%
\$10,001 to \$20,000	8%
\$20,001 to \$40,000	4%
More than \$40,000	3%

Taken cumulatively, the average small-business owner is spending at least \$12,000 every year to deal with the costs of regulation. We suspect that this number would be much higher if the survey specified the inclusion of even long-standing regulations such as ERISA in the respondent's calculation of regulatory costs, which many small firms likely just consider a cost of doing business rather than a regulatory burden.

STAFF REGULATORY RESPONSIBILITIES

The small-business owner is the number one regulatory expert in most businesses and handles the bulk of federal regulatory compliance. In one-quarter of small firms, the owner is spending more than 10 hours per month on federal regulatory compliance. Astoundingly, 14 percent of small-business owners report they spend more than 20 hours per month on federal regulations.

Which of the following people/departments in your firm spend the most time on federal regulatory compliance, including reading new or proposed regulations, making adjustments in work-flow to comply to new regulations, complying with existing regulations and all reporting required for existing regulations.

1	Myself
2	In-house accounting
3	External accounting
4	In-house HR department
5	In-house facilities manager
6	In-house IT department
7	In-house industry-specific department (i.e.: food safety)
8	External IT department
9	External industry-specific department (i.e.: food safety)
10	External HR department
11	Other

Approximately how much time do the following people/departments in your firm spend on federal regulatory compliance, including reading new or proposed regulations, making adjustments in work-flow to comply to new regulations, complying with existing regulations and all reporting required for existing regulations.

Staff Member	% spending more than 5 hours per month
Myself	40%
In-house accounting	34%
External accounting	22%
In-house HR department	23%
In-house facilities manager	16%
In-house IT department	15%
In-house industry-specific department (i.e.: food safety)	16%
External IT department	10%
External industry-specific department (i.e.: food safety)	10%
External HR department	9%
Other	8%

REGULATORY BURDEN BY AGENCY

Please select which one among the following regulatory agencies you find to be the most difficult to work with when it comes to regulatory burden and compliance assistance (excluding requirements of contractors who do business with these agencies).

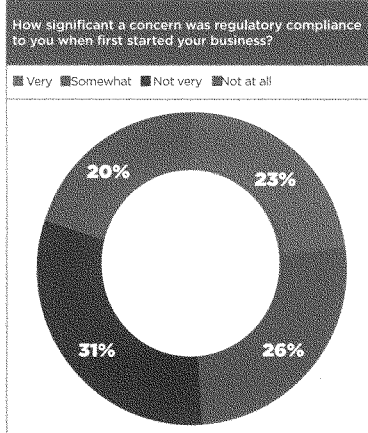
Internal Revenue Service	29%
Department of Labor	14%
Environmental Protection Agency	13%
A State Agency	9%
The Occupational Safety and Health Administration (OSHA)	7%
Department of Health and Human Services	6%
Equal Employment Opportunity Commission (EEOC)	3%
Department of Commerce	2%
Securities and Exchange Commission (SEC)	1%
Federal Trade Commission (FTC)	1%
Consumer Financial Protection Bureau (CFPB)	1%
Federal Communications Commission (FCC)	1%
Other	14%

Please select which of the following is the biggest cause of regulatory difficulty with the aforementioned agency.

The complexity of rules	23%
The cost of compliance with their rules	23%
Difficulty of interpreting and understanding rules	21%
The volume of existing rules	15%
The volume of new rules	9%
Rules contradict one another within the agency's purview	4%
This agency's rules contradict other agencies' rules	4%

The fact that “complexity of rules” and “difficulty interpreting and understanding rules” combined to comprise nearly half of all regulatory difficulties is clear indication of the need for eased complexity, overall streamlining and adherence to plain language statutes.

START-UP REGULATORY COSTS



When in your business did you start really worrying about compliance with regulations?

When I started it	38%
About six months in	14%
About two years in	15%
About five years in	7%
About 10 years in	12%
I am not worried about regulatory compliance	14%

More than half of small businesses say they really started worrying about regulations within the first year, underscoring that regulatory worries represent a major hurdle likely keeping many would-be entrepreneurs from starting their own business. These worries coupled with significant regulatory costs associated with a business' first year—\$83,019—and it's no wonder why we've seen lagging start-up rates in recent years.

\$83,019.23

AVERAGE REGULATORY START-UP COSTS



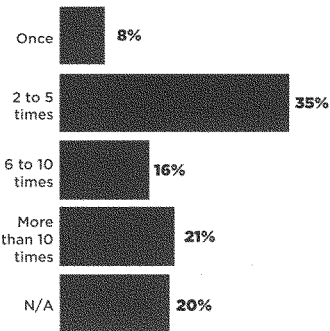
KEEPING ABREAST OF NEW REGULATIONS

The majority of small firms rely on business associations such as NSBA and the internet or other news sources for news on regulations that may impact their firms.

Where do you find out about regulations that may impact your firm? (check all that apply)

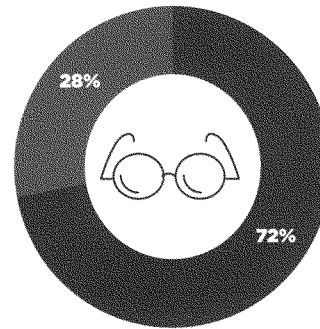
Internet / other media or news source	53%
Business associations (like NSBA or a Chamber of Commerce)	52%
External contractors (attorney/accountant/payroll firm)	43%
From other small-business owners	41%
Industry groups (like National Restaurant Association)	40%
The U.S. Small Business Administration (SBA) and/or its Office of Advocacy	32%
Staff (legal counsel/human resources)	21%
The Federal Register	20%
Congressional resources	7%
Other	4%

If yes, how often have you read through proposed regulations in the last FIVE years?



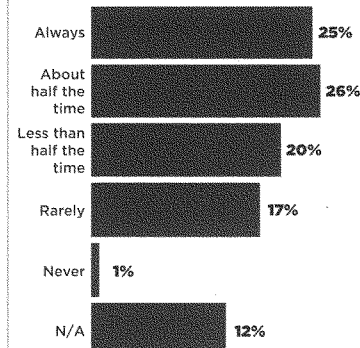
Have you ever read through proposed regulations?

■ Yes ■ No



Nearly three-in-four small firms say they have read through proposed regulations, yet 63 percent say that they only have to comply with those regulations they read half the time or less, which represents HUGE time waste for many small firms.

How often do you typically have to comply with the proposed regulations you read?

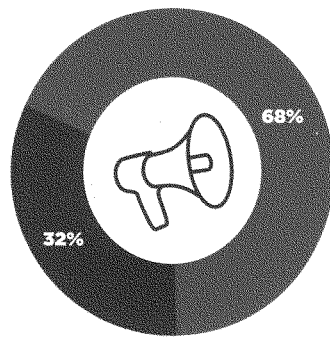


COMMENTING ON REGULATIONS

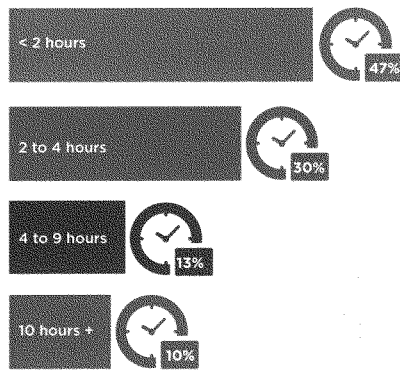
Despite the majority of small firms saying they read proposed regulations, just 32 percent have filed comments, likely due to the fact that it takes the majority of small firms two hours or more to do so. Furthermore, 38 percent say they don't submit comments because it is too time consuming or too confusing.

Have you ever submitted comments on a proposed regulation?

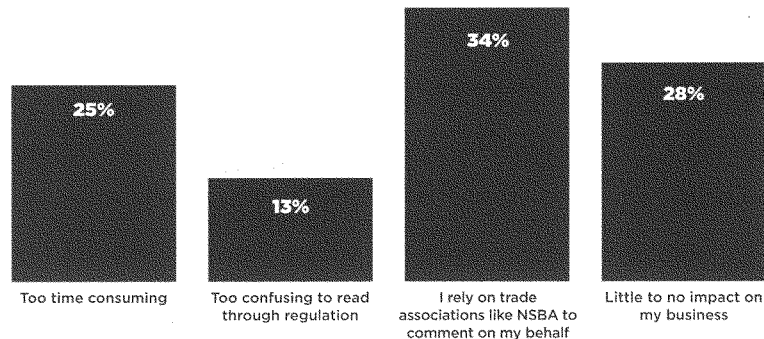
■ Yes ■ No



If yes, how long did submitting the comments take you?



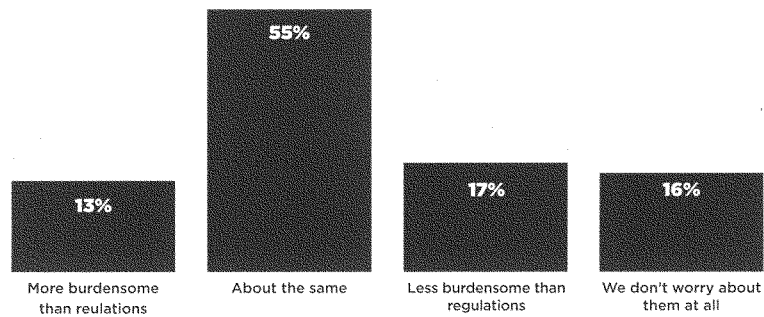
If no, why not?



GUIDANCE DOCUMENTS, INTERPRETATIONS & MORE

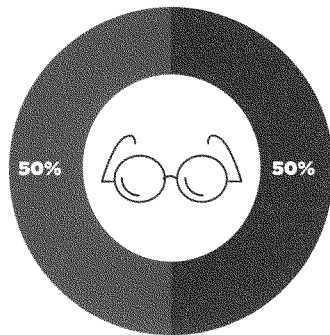
The policy focus often is on regulations. However guidance documents, interpretations and other memos related to regulatory changes are just as burdensome or more so than regulations for 68 percent of small businesses. Furthermore, the majority of small firms report having read through a guidance document and a memo of interpretation—yet another drain on their time and resources.

Compared to regulations, how significant of a burden are guidance memos and new interpretations for existing regulations for your business?



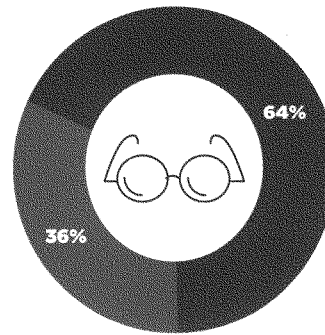
Have you ever read through memos of interpretation?

■ Yes ■ No



Have you ever read through guidance documents?

■ Yes ■ No

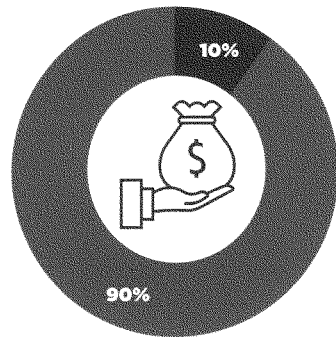


REGULATORY FINES

While the overwhelming majority of small firms have NOT been fined for regulatory noncompliance, those that have faced significant fines—the average cost of citations over five years was \$30,651.

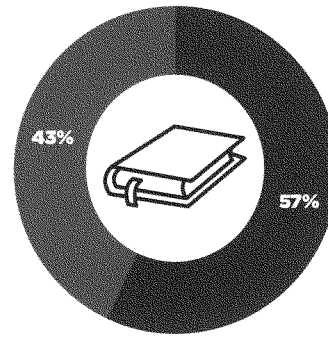
Has your business been fined ever for regulatory noncompliance?

■ Yes ■ No

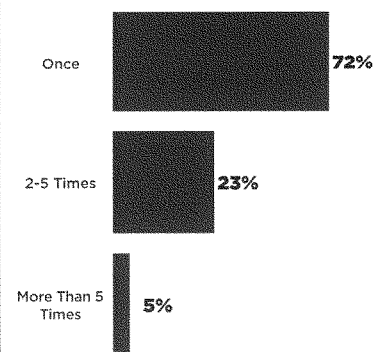


If yes, how often were these citations for the same or different rule?

■ The same rule ■ A different rule



If yes, how often in the last five years has your business been fined for regulatory noncompliance?



\$30,651.14
AVERAGE COST OF CITATIONS

IMPACTS OF REGULATION

Not surprising given the high level of confusion over the Affordable Care Act, health insurance was the number one employee benefit negatively impacted by high regulatory costs.

Please indicate which of the following employee benefits have been negatively impacted as a result of high compliance costs due to federal, state and local regulatory requirements. (check all that apply)

Health insurance	62%
Wage/salary increases	51%
Bonuses	36%
401K and other defined contribution retirement plans	33%
Competitive wages	32%
Paid time off	23%
Paid sick leave	22%
Pension plans and other defined benefit retirement plans	16%
Other	10%

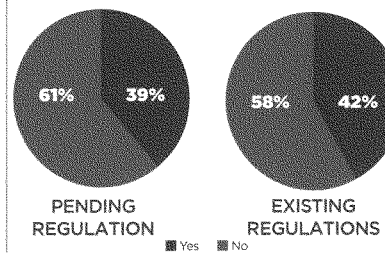
Seventy percent of small firms say that new regulations have a very or somewhat significant impact on their plans to grow or expand their business. More than half have held off on hiring a new employee due to regulatory burdens.

How significant an impact does regulatory uncertainty related to each of the following have on your plans to grow or expand your business?

	Very significant	Somewhat significant	Not very significant	Not at all
New regulations	39%	30%	18%	13%
The expectation of new regulations	37%	32%	17%	15%
Existing regulations	29%	35%	23%	14%

The impact of regulatory burden cannot be overstated: more than one-third have held off on business investment due to uncertainty on a PENDING regulation and 42 percent have held off due to uncertainty on the meaning or interpretation of an EXISTING regulation.

Have you delayed or halted any business investment besides new hires (expansions, product development, etc.) because of uncertainty on:

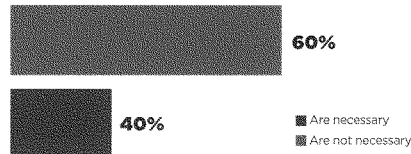


Please select how regulatory burdens and their associated costs impact your business overall. (check all that apply)

Held off on implementing growth strategies	53%
Held off on hiring a new employee	52%
Held off on salary increases for employees	50%
Delayed purchase of new equipment	43%
Increased prices	39%
Reduced benefits to employees	39%
Reduced the number of employees	29%
Unable to get financing	21%
Closed stores or branches	5%

REGULATORY POLICY

Would you say the majority of regulations covering your industry...



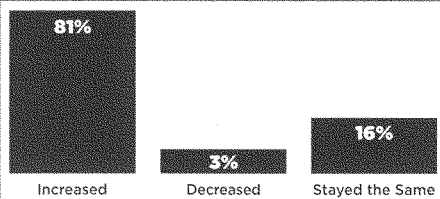
Certainly, NSBA and its members can see the need for some regulations, however 60 percent of small businesses surveyed said they believe the majority of regulations covering their industry are NOT necessary.

The U.S. Small Business Administration Office of Advocacy was ranked the number one most effective federal entity when it comes to protecting small businesses against unfair regulatory burdens.

How effective do you think each of the following currently are in protecting small businesses against unfair regulatory burdens? (Please do not indicate how effective they have the potential to be, just how effective they ARE today.)

	Very	Somewhat	Not at all	Not sure what this is
SBA Office of Advocacy	8%	32%	28%	33%
SBA Ombudsman	7%	25%	29%	39%
Small Business Regulatory Enforcement Fairness Act (SBREFA)	6%	24%	20%	49%
The Administration's Office of Information and Regulatory Affairs (OIRA)	4%	14%	27%	55%
Regulatory Flexibility Act	4%	16%	23%	58%

How do you think federal regulations have changed over the past five years?

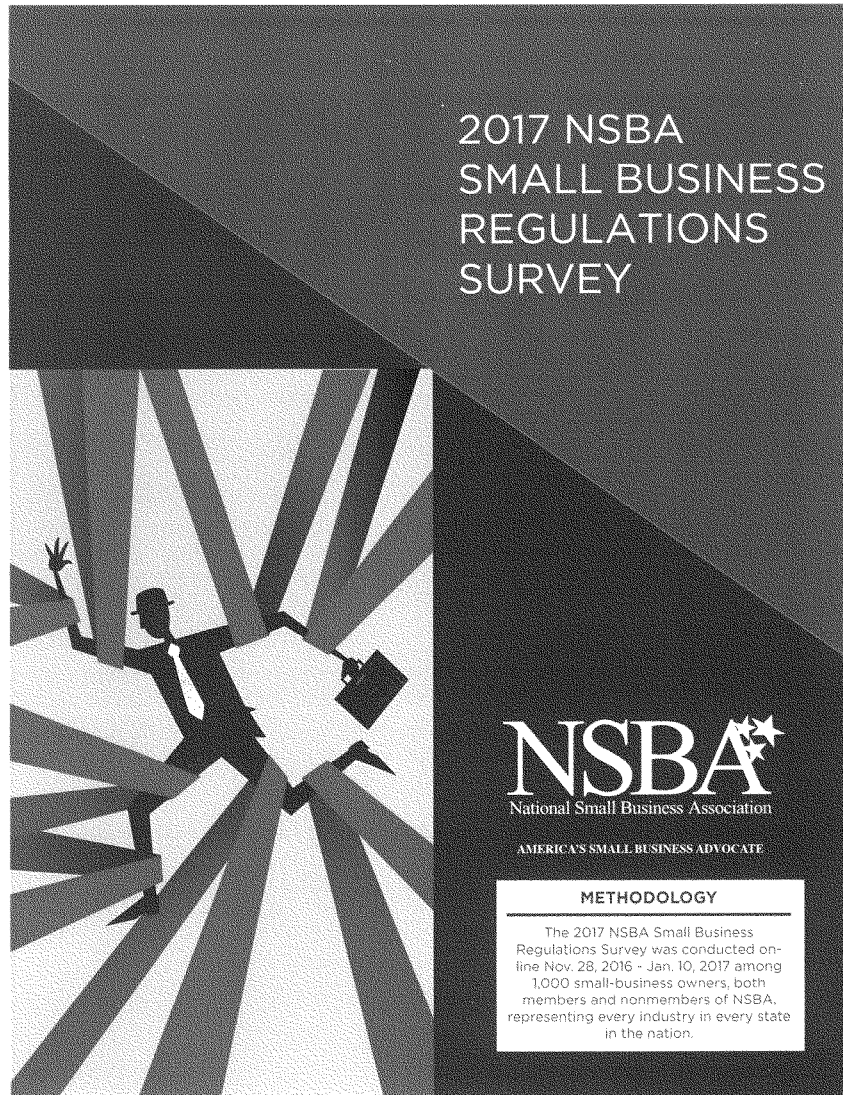


REGULATORY RELIEF IS POSSIBLE



To achieve meaningful relief and a rational regulatory regime, NSBA urges the adoption of a national regulatory budget, which would impose strict, enforceable constraints on the ability of federal agencies to impose regulatory costs on the public. Additionally, NSBA urges lawmakers to support policies that:

- Require that agencies consider indirect costs and detailed alternatives to minimize any significant adverse impact
- Require Regulatory Flexibility Analyses as a prerequisite to a final rule being issued
- Require increased economic analyses and the Office of Information and Regulatory Affairs (OIRA) to enhance its oversight efforts
- Require that agencies use plain writing when revising or drafting new regulations
- Allow for increased enforcement flexibility and the ability to grant common-sense exemptions for first-time offenders
- Streamline paperwork, consolidate forms and harmonize data and due dates
- Require a cost-benefit analysis on proposed regulations and paperwork
- Improve information collection by: 1) strengthening the Paperwork Reduction Act's requirement that agencies' chief information officers review and certify information collection requests; 2) requiring OIRA to develop stricter approval criteria; and 3) limiting the number of information requests an agency can issue per year





American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

**WRITTEN STATEMENT
OF
THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
FOR THE RECORD OF THE
FEBRUARY 15, 2017
HEARING OF
THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
ON
STARTUPS STALLING? THE TAX CODE AS A BARRIER TO
ENTREPRENEURSHIP**

AICPA's Written Statement for the Record
 U.S. House of Representatives, Committee on Small Business
 February 15, 2017 Hearing on "Startups Stalling? The Tax Code as a Barrier to Entrepreneurship"
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INTRODUCTION

Chairman Chabot, Ranking Member Velazquez, and Members of the House Committee on Small Business, thank you for the opportunity to testify today at the hearing on "Startups Stalling? The Tax Code as a Barrier to Entrepreneurship." My name is Troy Lewis. I am an Associate Teaching Professor at Brigham Young University. I am also a sole tax practitioner and the Immediate Past Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We applaud the leadership taken by the Committee to consider ways to promote entrepreneurship by addressing potential barriers in the Internal Revenue Code (IRC or "Tax Code"). Small businesses are the foundation of the U.S. economy, employing over half of the private-sector workforce and creating nearly two-thirds of this nation's net new jobs over the past decade and a half.¹

GOOD TAX POLICY

First, we should consider the features of an ideal tax system for small businesses. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and other *Principles of Good Tax Policy*² as explained in a report we recently updated and issued. Our tax system must be administrable, stimulate economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We believe these features are achievable if the following twelve principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Certainty
- Effective Tax Administration

¹ Small Business Administration Office of Advocacy, Frequently Asked Questions, September 2012; https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

² AICPA, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals, 2017; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/tax-policy-concept-statement-no-1-global.pdf>.

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- Information Security
- Neutrality
- Transparency and Visibility
- Accountability to Taxpayers
- Simplicity
- Economic Growth and Efficiency
- Minimum Tax Gap
- Appropriate Government Revenues

Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of any phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, cause tax consequences of business decisions to be nontransparent and hinder the ability for new entrepreneurs to grow their businesses. The use of phase-outs – in order to increase the effective tax rate – contributes to the complexity and lack of transparency of the present tax system. These rules also unfairly create marginal rates in excess of the statutory tax rate. We urge Congress to use tax reform as an opportunity to remove phase-outs and develop the best definition of taxable income or adjusted gross income by creating simple, transparent, tax rate schedules that are applied consistently across all rate brackets, eliminating additional hidden taxes.

We also urge you to make tax provisions permanent. For all businesses, and small businesses in particular, uncertainty in the Tax Code creates unnecessary confusion, anxiety, and financial burdens that impact cash flow, and, thus, a business's ability to hire and expand. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. New regulations, revenue procedures and notices come out daily, providing guidance on enacted laws. Extender bills pass annually only to expire, often within less than a month of enactment, leaving taxpayers unable to avail themselves of intended tax breaks and benefits. When a small business client asks a simple question such as "what is my tax rate," CPAs have to explain how it is not quite that simple to answer because there is the regular tax, the alternative minimum tax (AMT), the net investment income tax and the variety of phase-ins and phase-outs for numerous provisions that all impact an overall blended rate. America's entrepreneurs need a Tax Code that is simple, transparent, and certain.

AICPA PROPOSALS

We appreciate the opportunity to provide input as Congress develops tax reform policy for small businesses and their owners. In the interest of good tax policy and effective tax administration, we will address the following issues:

1. Tax Rates for Pass-through Entities

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2. Distinguishing Compensation Income
3. Cash Method of Accounting
4. Limitation on Interest Expense Deduction
5. Definition of "Compensation"
6. Net Operating Losses
7. Increase of Startup Expenditures
8. Alternative Minimum Tax Repeal
9. Border Adjustment Provisions
10. Mobile Workforce
11. Retirement Plans
12. Civil Tax Penalties
13. Tax Administration

1. Tax Rates for Pass-through Entities

As Congress moves forward with tax reform, it is important to recognize that a rate reduction for only C corporations is inappropriate. The vast majority of businesses are structured as pass-through entities (such as, partnerships, S corporations, or limited liability companies).³ In 2014, there were almost 25 million individual tax returns that included a non-farm sole proprietorship.⁴

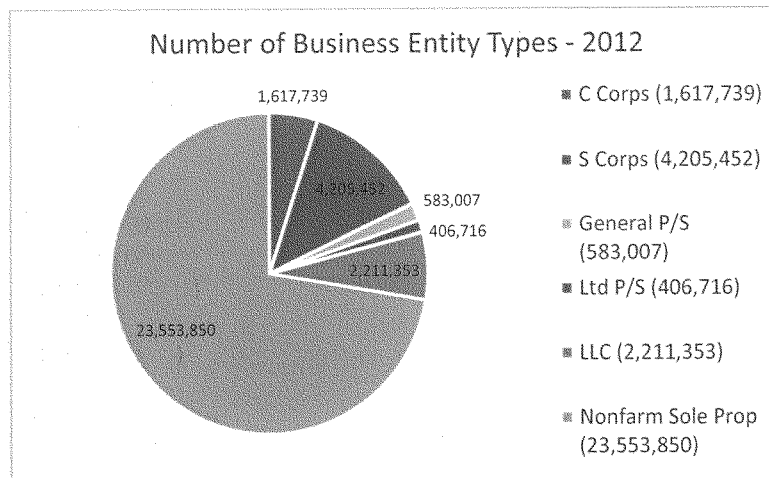
IRS data for 2012, the most recent data publicly available, indicates the following mix and numbers of business entity filings.⁵

³ Census Bureau, County Business Patterns, <http://www.census.gov/econ/cbp/>; Census Bureau, Nonemployer Statistics, <http://www.census.gov/econ/nonemployer/>.

⁴ IRS, Sole Proprietorship Returns, Tax Year 2014; <https://www.irs.gov/pub/irs-soi/soi-a-inpr-id1614.pdf>.

⁵ IRS, SOI Tax Stats – Integrated Business Data, Table 1: Selected financial data on businesses; 1980-2012; <https://www.irs.gov/uac/soi-tax-stats-integrated-business-data>. Table created by the AICPA using IRS data. IRS data on nonfarm sole proprietorships indicates the number has grown to 23,631,831 for 2014, a 4.6% increase from 2012. See IRS, *Sole Proprietorship Returns, Tax Year 2014*, Figure L; <https://www.irs.gov/pub/irs-soi/soi-a-inpr-id1614.pdf>.

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Congress should continue to encourage, or more accurately – not discourage, the formation of sole proprietorships and pass-through entities because these business structures provide the flexibility and control desired by many new business owners as opposed to corporations which are subject to more formalities. Entrepreneurs generally do not want to create entities that require extra unnecessary legal obligations (such as holding annual meetings of a board of directors) or offer limited liability. They prefer business structures that afford immediate tax advantages, such as the flow-through of early stage losses and a single layer of taxation. As a business grows, however, it may need to change its structure to raise additional equity funding or bring on more shareholders (including employee-shareholders).

If Congress decides to lower income tax rates for C corporations⁶ (which are generally larger businesses), small businesses should also receive a rate reduction. Tax reform should not disadvantage sole proprietorships and pass-through entities at the expense of furthering larger C corporations.

2. Distinguishing Compensation Income

We recognize that providing a reduced rate for active business income of sole proprietorships and pass-through entities will place additional pressure on the distinction

⁶ House Republican's Tax Reform Task Force, *A Better Way: Our Vision for a Confident America - Tax*, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

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between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by using traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the Secretary of the Treasury. Changes to existing payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses.

We encourage Congress to consider the existing judicial guidance on reasonable compensation that reflects the type of business (for example, labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles). There is existing law developed by judicial decisions relating to reasonable compensation.

We acknowledge that reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, we suggest that the Internal Revenue Service (IRS) take additional steps to improve compliance and administration in this area. For example, the creation of a new tax form (or preferably, modification of an existing form, such as Form 1125-E, Compensation of Officers) or a worksheet maintained with the taxpayer's tax records, would allow businesses to indicate the factors considered in determining compensation in a consistent manner. These potential factors include:

- a. Approximate average hours per week worked by all owners;
- b. Approximate average hours worked per week by non-owner employees;
- c. The owner's years of experience;
- d. Guidance used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics); and
- e. Book value and estimated fair market value of assets that generate income for the business.

Changes are also necessary for existing payroll tax rules to require partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes. These types of changes to existing payroll tax rules will facilitate small business compliance. The partners and proprietors are not treated as "employees," but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services. Similar rules requiring reasonable compensation currently exist in connection with S corporations and such owners are considered employees of the S corporation. The broader inclusion of partners

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and proprietors in more well defined compensation rules, should facilitate and enhance the development of appropriate regulations and enforcement in this area.

The AICPA believes there are advantages of this reasonable compensation approach for owners of all business types. These advantages include:

- a. Fairness that respects the differences among business types;
- b. A reduced reliance by both taxpayers and the IRS on quarterly estimated tax payments for timely matching of the earning process and tax collection;
- c. Diminished reliance on the self-employment tax system (since businesses would include payroll taxes withheld from owners and paid for owners along with their employees); and
- d. Simplification from uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.

In former Ways & Means Chairman Dave Camp's 2014 discussion draft,⁷ a proposal was included to treat 70 percent of pass-through income of an owner-employee as employment income. While this proposal presents a simple method of determining the compensation component, it would result in an inaccurate and inequitable result in too many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option. Small businesses need simplicity and clarity in the rules. For example, the proposal must make clear that the existence and the amount of the safe harbor is not a maximum amount permitted but that the reasonable compensation standard utilized for corporations will remain available to sole proprietorships and pass-through entities. These rules will provide a uniform treatment among closely-held business entity types.

3. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting. The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income. Therefore, entrepreneurs often choose this method for small businesses. We are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as partnerships and S corporations. Requiring businesses to switch to the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth. A required switch to the accrual method affects

⁷ H.R. 1, "The Tax Reform Act of 2014,"
https://waysandmeans.house.gov/UploadedFiles/HR_1_FINAL.pdf.

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many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

- 1) Discourage natural small business growth;
- 2) Impose an undue financial burden on their individual owners;
- 3) Increase the likelihood of borrowing;
- 4) Impose complexities and increase their compliance burden; and
- 5) Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

As the AICPA has previously stated,⁸ we believe that Congress should not further restrict the use of the long-standing cash method of accounting for the millions of U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method. We believe that forcing more businesses to use the accrual method of accounting for tax purposes increases their administrative burden, discourages business growth in the U.S. economy, and unnecessarily imposes financial hardship on cash-strapped businesses.

4. Limitation on Interest Expense Deduction

Another important issue for small businesses is the ability to deduct their interest expense. New business owners have interest from small business loans they incur to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and even to build credit for larger future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (to the extent of interest income) would effectively eliminate the benefit of a valid business expense for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is

⁸ AICPA comment letter on the "Continued Availability of Cash Method of Accounting," August 15, 2013; http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.08.15_Comments_on_Continued_Availability_of_Cash_Method_of_Accounting.pdf, AICPA written statement before the House Committee on Ways And Means, dated May 15, 2013, Small Business and Pass-through Entity Tax Reform Discussion Draft; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-WRITTEN-STATEMENT-May-15-2013-hwmc-srsubcomte-camp-small-bus-submit.pdf>, and AICPA written statement before the House Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access, dated July 10, 2014, Hearing on "Cash Accounting: A Simpler Method for Small Firms?"; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA%20WRITTEN%20STATEMENT%20July%2010%202014%20to%20House%20Subct%20on%20Economic%20Growth%20Tax%20and%20Capital%20Access.pdf>.

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paired with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering much larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to \$500,000 of acquisitions per year under section 179 (\$510,000 for 2017) and deduct all associated interest expense. One tax reform proposal⁹ under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment in the first year. However, since small businesses do not generally purchase large amounts of new assets, this proposal would not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only takes away an important deduction for many small businesses who are forced to rely on debt financing to cover their operating and expansion costs.

5. Definition of "Compensation"

Tax reform discussions have recently considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct. In other words, should businesses lose some of their current payroll-type deductions if employees are not required to report those same compensation amounts as income?

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation they have paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

6. Net Operating Losses

Congress should also provide tax relief to small businesses in the calculation of benefits related to net operating losses (NOLs). An NOL is generally the amount by which a taxpayer's business deductions exceed its gross income. Corporations currently operating at a loss can benefit from carrying these NOLs back or forward to offset taxable income in prior or future years. According to the current rules, these losses are not deducted in the

⁹ House Republican's Tax Reform Task Force, A Better Way: Our Vision for a Confident America, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

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year generated, but carried back two years and carried forward 20 years to offset taxable income in such years.

One of the purposes of the NOL carryback and carryover rules is to allow a corporation to better reflect its economic position over a longer period of time than generally is allowed under the restraint of the annual reporting period. Since 1987, our experience with the 90 percent AMT limitation on the use of NOLs shows that this limitation often imposes a tax on corporations, especially small businesses in their early growth years, when such businesses are still struggling economically. Therefore, a proposal¹⁰ for a 90 percent limitation on NOLs imposes an artificial restriction on a company's use of business losses and discriminates against companies with volatile income which could potentially pay more tax than companies with an equal amount of steady income over the same period.

For sole proprietors, the calculation of the NOL is overly complicated. Congress should simplify the calculation while retaining the carryback option for small businesses. Most startup businesses are formed as pass-through entities¹¹ and the initial startup losses incurred are "passed down" and reported on the owners' tax returns. Because individual taxpayers report both business and nonbusiness income and deductions on their returns, the required calculations to separate allowed business losses from disallowed personal activities is complex.¹² Individual business owners would benefit from more specific guidance on NOL computations.

7. Increase of Startup Expenditures

In the interest of economic growth, we encourage Congress to consider increasing the expensing amount for startup expenditures. Section 195 allows immediate expensing of up to \$5,000 of startup expenditures in the tax year in which the active trade or business begins. This amount is reduced dollar for dollar once total startup expenditures exceed \$50,000, with the excess amortized ratably over 15 years. Thus, once startup expenditures exceed \$55,000, all of these expenditures are amortized over 15 years. The rationale for the \$5,000 expensing was to "help encourage the formation of new businesses that do not require significant startup or organizational costs."¹³ These dollar amounts, added in 2004, are not adjusted for inflation. Only for tax years beginning in 2010, the \$5,000 was

¹⁰ House Republican's Tax Reform Task Force, *A Better Way: Our Vision for a Confident America - Tax*, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

¹¹ Center for American Progress, "Ending the Pass-Through Tax Loophole for Big Business," August 2016; <https://cdn.americanprogress.org/wp-content/uploads/2016/08/05070331-PassthruTaxationAug.pdf>.

¹² IRS Publication 536; <https://www.irs.gov/pub/irs-pdf/p536.pdf>.

¹³ P.L. 108-357 (10/22/04), American Jobs Creation Act, Sec. 902; Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-03*, May 31, 2005, p. 504.

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increased to \$10,000 and the \$50,000 phase-out level was increased to \$60,000. This change was described as "promoting entrepreneurship."¹⁴

The AICPA recommends increasing the \$5,000 and \$50,000 amounts of section 195 and adjusting them annually for inflation. These changes will further simplify tax compliance for small businesses by reducing (or eliminating) the number of such businesses that must track and report amortization of startup expenses over a 15-year period. In addition, as was suggested for the 2004 and 2010 legislative changes, the larger dollar amounts will better encourage entrepreneurship. Higher dollar amounts also reflect the costs for legal, accounting, investigatory, and travel that are frequently incurred when starting a new business. Also, in light of the increased, inflation-adjusted dollar amounts under section 179¹⁵ to help small businesses, it is appropriate to similarly increase the section 195 dollar amounts and adjust them annually for inflation.

8. Alternative Minimum Tax Repeal

Congress should repeal AMT for both individuals and corporations. The current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a significant area of complexity of the Tax Code requiring extra calculations and recordkeeping. AMT also violates the transparency principle in masking what a taxpayer is allowed to deduct or exclude, as well as the taxpayer's marginal tax rate. Owners of small businesses, including those businesses operating through pass-through entities and C corporations of a size beyond the AMT exception for small C corporations, are increasingly at risk of being subject to AMT.

The AMT was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. However, small businesses suffer a heavy burden because they often do not know whether they are affected until they file their taxes. They must constantly maintain a reserve for possible AMT, which takes away from resources they could allocate to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. IRC Sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation is required for all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the

¹⁴ The one year change to the §195 dollar amounts was made by P.L. 111-240 (9/27/10), the Small Business Jobs Act of 2010, Sec. 2031(a); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111th Congress*, JCS-2-11, March 2011, p. 474.

¹⁵ P.L. 114-113 (12/18/15), Sec. 124(a).

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treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity also affects the IRS's ability to meaningfully track compliance.

9. Border Adjustment Provisions

It is important to consider how border adjustment provisions (a/k/a destination-based cash flow tax) would impact small businesses. Recent tax reform discussions have included suggestions to exclude export sales from revenue and disallow a deduction for imported goods and services. These provisions could impact businesses of all sizes, including small businesses.

Many service providers, such as accounting firms, are locally-operated small businesses. However, the demands on our profession have evolved over the last 20 years as more of our clients are engaging in global markets to remain competitive. As a result, small accounting firms frequently participate in global alliance networks to service their clients since they do not have in-house expertise on international tax issues and treatises or knowledge of the tax rules of foreign countries. The forced reliance on such services, which may be considered "imported" and therefore nondeductible, may impact their ability to continue to service their clients in the U.S.

10. Mobile Workforce

The AICPA supports legislation similar to H.R. 2315, the Mobile Workforce State Income Tax Simplification Act of 2015, from the 114th Congress, which provides a uniform national standard for non-resident state income tax withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.¹⁶ We expect the same cosponsors to soon introduce a similar bill.

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small businesses and family businesses that operate

¹⁶ AICPA testified at the U.S. House Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access hearing: "Keep It Simple: Small Business Tax Simplification and Reform, Main Street Speaks," on April 13, 2016, available at <https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/aicpa-comments-mobile-workforce-subcom-small-bus-hearing.pdf>.

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interstate, are subject to a multitude of burdensome and often bewildering non-resident state income tax withholding rules. These businesses currently face unnecessary administrative burdens to understand the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is quite complicated and costly. The documentation takes a lot of time, not to mention the loss in economic productivity for small businesses.

Legislation very similar to H.R. 2315, which passed in the 114th Congress, would provide long-overdue relief from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass this type of legislation that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

11. Retirement Plans

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. Congress should eliminate the unnecessary complexity by reducing the number of choices for the same type of plan while keeping the desired goal intact: affording employers the opportunity to offer a contributory deferral plan to their employees and allowing those employees to use a uniform plan to save for retirement.

Startup business owners are inundated with a myriad of new business decisions and concerns. These individuals may have expertise in their business product or service, but rarely are they experts in areas such as retirement plan rules and regulations. We encourage Congress to consider creating a uniform employee contributory deferral plan to ease this burden for small businesses.

12. Civil Tax Penalties

Congress should carefully draft penalty provisions and the Executive Branch should fairly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing innocent small businesses owners (i.e., unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws.

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On the other hand, overbroad, vaguely-defined, and disproportionate penalties create an atmosphere of arbitrariness and unfairness that can discourage voluntary compliance.

The AICPA has concerns¹⁷ about the current state of civil tax penalties and offers the following suggestions for improvement:

a. Trend Toward Strict Liability

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. Legislation should avoid mandating strict liability penalties. Over the past several decades, the number of increasingly severe civil tax penalties have grown, with the Tax Code currently containing eight strict liability penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).¹⁸

b. An Erosion of Basic Procedural Due Process

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS's FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

c. Repeal Technical Termination Rule

We recommend¹⁹ the repeal of section 708(b)(1)(B) regarding the technical termination of a partnership.²⁰ A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50 percent or more of the

¹⁷ See the "AICPA Tax Penalties Legislative Proposals," submitted to Congress in April 2013; <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-legislative-proposals-penalties-2013.pdf>; and the "AICPA Report on Civil Tax Penalties," submitted April 2013; <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-report-civil-tax-penalty-reform-2013.pdf>.

¹⁸ Section 6662A, 6664(d).

¹⁹ AICPA submitted comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, dated January 12, 2015; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf>.

²⁰ AICPA submitted letters and written statements on Option 1 and Option 2 of Chairman Camp's Small Business Tax Reform Draft: See Option 1 comments at "AICPA testimony on Small Business and Pass-through Entity Tax Reform," dated May 17, 2013; http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.05.13_Testimony_on_Small_Business_and_Pass-Through_Entity_Tax_Reform_Discussion_Draft.pdf; and Option 2 comments, dated July 30, 2013; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-Option-2%20comments-7-30-13.pdf>.

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total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30 percent change (a minority interest) in one year followed by a 25 percent change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the business is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. This technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

d. Late Filing Penalties of Sections 6698 and 6699

Sections 6698 and 6699 impose a penalty of \$200 per owner related to late-filed partnership or S corporation returns. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause.

The AICPA proposes that a partnership, comprised of 50 or fewer partners, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, be considered to have met the reasonable cause test and not be subject to the penalty imposed by section 6698 or 6699 if:

- The delinquency is not considered willful under section 7423;
- All partnership income, deductions and credits are allocated to each partner in accordance with such partner's capital and profits interest in the partnership, on a pro-rata basis; and
- Each partner fully reported its share of income, deductions and credits of the partnership on its timely filed federal income tax return.

e. Failure to Disclose Reportable Transactions

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Tax Code. The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to this penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20 percent (if the transaction was disclosed) and 30 percent (if the transaction was not disclosed). A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial

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authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not proper. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

For example, a company that engaged in a "listed" transaction which gave rise to a deduction of \$25,000 over the course of two years and inadvertently failed to report the transaction may be subject to a \$200,000 penalty per year, for a total penalty of \$400,000. The penalty can apply even if the deduction is allowable.

We propose an amendment of section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

f. 9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who inadvertently miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list²¹ of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities.

g. Form 5471 Penalty Relief

On January 1, 2009, the IRS began imposing an automatic penalty of \$10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed with a delinquent Form 1120 series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c) companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations.

²¹ AICPA letter on "Tax Reform Administrative Relief for Various Statutory Elections," submitted January 23, 2015; <http://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-letter-to-congress-on-9100-relief-1-23-15submitted.pdf>.

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The AICPA has submitted recommendations²² regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Tax Code.

13. Tax Administration

Our profession is committed to improving the taxpayer and tax preparer experience when interacting with the IRS. The AICPA Council passed a resolution regarding tax administration²³ and fully supports rebuilding the agency into a modern and efficient 21st century administrator of the nation's tax system.

In order for small businesses and their tax practitioners to receive the assistance they need on tax issues, it is essential for the IRS to focus on:

- a. Utilizing modern and secure technology;
- b. Developing and continuing to hire and train knowledgeable employees; and
- c. Tailoring their processes and systems around the needs and wants of their "customers."

By focusing on the factors listed above, the IRS will become a "Service First" agency that meets the needs of small business owners.

CONCLUDING REMARKS

Small businesses and their tax practitioners are interested in, and need, tax simplification. Compliance burdens for entrepreneurs and small businesses are currently too heavy, both in terms of time required and out-of-pocket expense. While there are certainly costs associated with simplifying tax legislation, it is important to recognize that reforming our tax system will eliminate significant compliance burdens.

The proliferation of new income tax provisions since the 1986 tax reform effort has led to compliance hurdles for taxpayers, administrative complexity, and enforcement challenges for the IRS. We encourage you to examine all aspects of the Tax Code to identify barriers

²² AICPA submitted comments to the IRS, dated March 26, 2013; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-Form-5471-Penalties-3.26.13.pdf>.

²³ AICPA Council Resolution Regarding Tax Administration, May 17, 2015; <https://www.aicpa.org/Advocacy/Tax/downloadabledocuments/council-resolution-on-tax-administration.pdf>.

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for small businesses and their owners. The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will significantly reduce small businesses' compliance costs and fuel economic growth.²⁴ We look forward to working with the Committee in the 115th Congress as you continue to address the needs of small businesses.

²⁴ The AICPA maintains a tax reform resource center website at:
<http://www.aicpa.org/InterestAreas/TaxResources/Specializedguidance/Taxreform/Pages/tax-reform-resource-center.aspx>.

Questions from Representative Radewagen to David Burton

1. In your opinion, should the territories have a standardized tax code (Where all 5 territories share one common tax code) or should each territory have its own separate tax code that is tailored to each of the territories?

No. Tax competition at the subnational level is positive. Moreover, state, territorial and local governments should determine their own tax and spending levels and maintain control over the structure and financing of their government.

2. In your opinion, should the territories receive a territorial tax credit or special dispensations to encourage outside investment/ development?

No. Tax preferences generally reduce rather than enhance social well-being.

3. What are the pros and cons of income earned in the territories being treated as foreign earned income?

I do not have a well-developed position on this issue.

4. What are the pros and cons of income earned in the territories being treated as domestic earned income?

I do not have a well-developed position on this issue.

5. Supposing that the IRC does not change, what reforms can be made to the IRC that could help entrepreneurs and small businesses in the territories?

Lower marginal tax rates, permitting the immediate deduction of capital expenses (expensing) and simplification that reduces compliance costs would do the most to help small businesses.

David Burton

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Kyle Pomerleau
Director of Federal Projects
Tax Foundation

March 28, 2017

Chairman Steve Chabot
Committee on Small Business
U.S. House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Chabot:

Thank you for sending the questions submitted by Representative Radewagen. My answers are below:

1. I do not have a strong opinion on whether all five inhabited U.S. territories should have a standardized tax code.

Under current law, three of the five territories have "mirror code" tax systems, and are required to use the U.S. Internal Revenue Code (I.R.C.) as the basis for their tax collections. However, all three territories – Guam, the Northern Mariana Islands, and the U.S. Virgin Islands – have varying levels of authority to enact different tax rules, alongside or in place of the I.R.C.

Meanwhile, the remaining two territories, American Samoa and Puerto Rico, are not required to use the I.R.C. as the basis for their tax collections. Nevertheless, American Samoa has chosen to structure its tax laws in a manner broadly similar to the I.R.C.

Lawmakers interested in the question of a standardized tax code for the territories would do well to examine the case study of Puerto Rico, the only territory to extensively decouple its tax system from that of the U.S. federal government.

More generally, because all five U.S. territories have significantly different economic conditions and revenue requirements, it could potentially be advantageous for each territory to have a separate tax code, tailored to its needs. On the other hand, it is likely that the territories with "mirror code" tax systems derive significant administrative advantages from having a tax code that is based off of the I.R.C.

2. In my opinion, the U.S. federal income tax code should not contain a "territorial tax credit" for conducting business in U.S. territories.

Ideally, lawmakers should endeavor to make the federal tax code neutral between different economic activities, so that taxpayers make decisions based on the economic merits, rather than tax considerations. If a tax code deviates from the principle of neutrality, taxpayers may be discouraged from engaging in socially beneficial activities because of an especially high tax burden; on the flip side, they may be encouraged to engage in socially wasteful activities because of tax incentives to do so.

Adding a "territorial tax credit" would likely move the U.S. tax code further away from neutrality, by encouraging U.S. businesses to conduct economic activities in the territories because of tax considerations.

3. Under current law, income earned in U.S. territories is generally considered "foreign" income for the purposes of the federal income tax. This means that, when a business or individual earns income in one of the five U.S. territories, the income is generally subject to taxes by the territory in question, rather than by the U.S. federal government.

An important exception to this rule occurs when a business or individual that resides in the U.S. mainland earns income in one of the five U.S. territories. In this case, when the income is brought back to the U.S. mainland, it may be subject to a second layer of tax by the U.S. federal government. This is because the U.S. federal income tax is "worldwide": designed to tax income earned anywhere in the world by residents of the U.S. mainland.

The principal advantage of treating income earned in U.S. territories as foreign-source income is that each territory is able to collect revenue from the economic activities in its jurisdiction, rather than having the U.S. federal government collect revenue on these activities.

The chief disadvantage of the current situation is that income earned in U.S. territories by businesses or individuals residing in the U.S. mainland is potentially subject to two layers of taxation: once by the territorial government, when the income is earned, and once by the federal government, when the income is brought back to the U.S. mainland. This creates a disadvantageous tax climate for U.S. mainland companies to invest in the territories.

It is not entirely clear to me what it would mean for income earned in the U.S. territories to be treated as "domestic" income for the purposes of U.S. tax law.

4. Perhaps this means that the U.S. federal government would end the deferral of income earned by U.S. mainland individuals and businesses in the territories. In this scenario, the income in question would be taxed by the federal government in the year it is earned, rather than when it is brought back to the U.S. This would likely be an economically disadvantageous policy change, which would discourage investment by U.S. mainland companies in the territories.

Another interpretation is treating income earned in the U.S. territories as "domestic" means that the U.S. federal government would effectively replace the territorial governments as tax administrator, collecting taxes on economic activity in the territories and remitting the revenues to each territorial government. This would likely be an economically advantageous policy change, as it would end the double tax on income earned in U.S. territories by mainland businesses. However, it could remove autonomy from territorial governments, particularly those without "mirror code" tax systems.

5. One change that could help entrepreneurs and small businesses in the territories would be moving away from the federal "worldwide" tax system, as it applies to income earned in the U.S. territories. By removing the layer of tax levied by the U.S. federal government on income earned by U.S. mainland businesses in the territories, this change would help create a more advantageous investment climate for mainland companies operating in the territories.

Sincerely,

Kyle Pomerleau

March 2, 2017

The Honorable Steve Chabot
Chairman
House Small Business Committee
2371 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Nydia Velázquez
Ranking Member
House Small Business Committee
2302 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Chabot and Ranking Member Velázquez:

In connection with the House Small Business Committee's recent hearing on *Start-ups Stalling? The Tax Code as a Barrier to Entrepreneurship*, we are submitting as a statement for the record the attached letter urging you to preserve the current availability of like-kind exchange treatment as part of any business tax reform. Thank you for your consideration and your leadership on these important issues.

Sincerely,

The Like-Kind Exchange Stakeholder Coalition

THE LIKE-KIND EXCHANGE STAKEHOLDER COALITION

November 29, 2016

Mr. Jim Carter
Tax Policy Lead
Presidential Transition
1800 F Street NW
Washington, DC 20006

Dear Mr. Carter:

As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code (“Code”). We further encourage retention of the current unlimited amount of gain deferral.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that taxpayers do not immediately recognize a gain or loss when they exchange assets for “like-kind” property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other “boot” is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the U.S. by allowing funds to be reinvested back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like-kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst & Young found that either repeal or limitation of like-kind exchanges could lead to a decline in U.S. GDP of up to \$13.1 billion annually.¹ The Ernst & Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, etc. A 2016 report by the Tax

¹ *Economic Impact of Repealing Like-Kind Exchange Rules*, ERNST & YOUNG (March 2015, Revised November 2015), at (iii), available at <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.

Foundation estimated even greater economic contraction – a loss of 0.10% of GDP, equivalent to \$18 billion annually.²

Companies in a wide range of industries, business structures, and sizes rely on the like-kind exchange provision of the Code. These businesses—which include real estate, construction, agricultural, transportation, farm / heavy equipment / vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.³ The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A \$1 million limitation of gain deferral per year, as proposed by the Administration⁴, would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle / equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property / casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

² *Options for Reforming America's Tax Code*, Tax Foundation (June, 2016) at p79, available at <http://taxfoundation.org/article/options-reforming-americas-tax-code>.

³ David Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, available at <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.

⁴ *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, at 107, available at <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>.

Thank you for your consideration of this important matter.

Sincerely,

Air Conditioning Contractors of America
American Car Rental Association
American Rental Association
American Seniors Housing Association
American Truck Dealers
American Trucking Associations
Associated Equipment Distributors
Associated General Contractors of America
Avis Budget Group, Inc.
Building Owners and Managers Association (BOMA) International
C.R. England, Inc.
Equipment Leasing and Finance Association
Federation of Exchange Accommodators
International Council of Shopping Centers
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of REALTORS®
National Automobile Dealers Association
National Business Aviation Association
National Multifamily Housing Council
National Ready Mixed Concrete Association
National Stone, Sand and Gravel Association
Truck Renting and Leasing Association



**Start Ups Stalling? The Tax Code as a Barrier to
Entrepreneurship**

February 15, 2017

Statement for the Record

Karen Kerrigan

President & CEO

Small Business & Entrepreneurship Council

Committee on Small Business

United States House of Representatives

The Honorable Steve Chabot, Chairman

The Honorable Nydia Velazquez, Ranking Member

PROTECTING SMALL BUSINESS, PROMOTING ENTREPRENEURSHIP

The Small Business & Entrepreneurship Council is grateful that the Committee on Small Business is investigating the challenges of the U.S. tax code as they related to entrepreneurship and small business growth. Small business owners are excited about the prospect for tax reform in the coming year. We are hopeful that the Congress will move forward with a modern framework that brings simplicity, fairness and lower taxes to our nation's small businesses and entrepreneurs. As committee members well know, strong and sustainable economic and job growth is dependent upon a successful small business sector, as well as healthy startup activity.

The Small Business & Entrepreneurship Council (SBE Council) is a nonpartisan advocacy, research and education organization dedicated to protecting small business and promoting entrepreneurship. For twenty-four years, SBE Council has worked to advance a range of initiatives and policies to strengthen the ecosystem for startups and small business growth. Our organization and its members deeply appreciate the work and dedication of Small Business Committee members, and we have been honored to work with the committee since our founding.

While entrepreneurship in the U.S. has improved over the last several of years, the downward trend in new business creation remains. This started well before the Great Recession but obviously new business creation tumbled hard during this dark economic period. Unfortunately, entrepreneurship has never fully recovered. From 2009-2011 there were more business closures than startups, according to the SBA Office of Advocacy. The trend has slightly reversed course, but our economy does not have near the volume of entrepreneurial activity and business entities (as a share of the relevant population) that existed prior to the Great Recession.

According to an analysis published by SBE Council's chief economist Raymond Keating, the significant decline in new business creation during the last decade has been felt across the board—among unincorporated and incorporated self-employed, startups and employer firms. Mr. Keating's **"gap" analysis finds** an estimated shortfall of anywhere from 867,000 to 4.8 million businesses over the past decade, with "3.7 million missing businesses being quite reasonable based on a combination of the most often cited self-employed and employer firms data."

Economic conditions and uncertainty, access to capital, regulatory uncertainty, and the aversion to risk are some of the reasons as to why individuals have not pursued, or are not pursuing, entrepreneurship. From SBE Council's perspective, making policy changes that help to reduce risks along with reforms that lower government costs and burdens is especially critical to enabling higher startup activity. The tax code is one such area that requires an overhaul, with small business health and growth being a priority for how this is accomplished.

SBE Council is on record supporting various principles and proposals for tax reform, including: lower rates for all businesses entities, full expensing, low capital gain taxes, the elimination of AMT and death taxes, and making reporting and compliance as simple as possible.

It is our hope that members of Congress also use this opportunity to update or modernize various measures in the tax code that advance simplicity and cut compliance costs, which are especially painful for startups and new business owners.

Here are some of those ideas:

Update the Threshold for Self-Employment Taxes: When I talk to people who help teenagers and young entrepreneurs start businesses, they continually report that these risk-takers are totally turned off by a complex tax code that immediately eats their profits. Self-employment taxes kick in at \$400, which is 15.3 percent of profits. The \$400 threshold has not been changed since the 1950s, yet the standard deduction on federal income tax is adjusted annually. If the self-employment tax floor has been adjusted at the same rate as the standard deduction, it would be more than \$6,000. It makes sense to update it, and relieve entrepreneurs of the burden that hits their businesses at such low business revenue levels.

Liberalize the 100% Capital Gains Exclusion for Startups: SBE Council fully supported efforts that made the 100% capital gains tax exclusion permanent for startups. But the exclusion needs to be improved upon so that more startups benefit from it. First, the exclusion is limited to C corporations, and SBE Council believes it should be made available to S corps, LLCs and other business entities. Secondly, the exclusion is disallowed in ventures involved with personal services, law, banking, finance, leasing, hospitality, health, farming and mining. There is innovation occurring in all these spaces, and in several of these sectors consumers and small businesses would benefit from more competition and choices. The targeted and limited exclusion, as it now stands, is picking winners and losers in the marketplace and ignores how most businesses—and in this case new businesses—are organized. Ideally, capital gains taxes would be eliminated altogether, but if the current exclusion is going to be retained it can be made more robust to help drive startup activity across all industry sectors.

Update and Clarify the Independent Contractor Test: SBE Council believes it is important to modernize the current test given the prevalence of the “gig” economy and the need for clarity. The current 20-factor test is arbitrary, but can be simplified to three or four factors. We believe there is an approach to reforming the 20-factor test that demonstrates contractor independence through written contracts, how the contractor is compensated, expenses incurred by the contractor, and how the work is performed. Businesses should be encouraged to do business with individuals who want to contract on a per-project basis, and on their own terms. The “gig” economy supports this freedom, and the government should not deter opportunity through the subjective and outdated 20-factor test.

Indexing 1244 Small Business Stock to Inflation to Boost Capital in Startups: Again, here is an opportunity to update existing law, which has not been done since 1978. This minor change could unlock and mobilize more capital toward startups. Qualified small business tax (loss) treatment under Section 1244 of the tax code allows for investors to deduct losses taken on investments in

C Corp startups to be deducted against ordinary income. This measure was passed as part of the Small Business Investment Company Act of 1958, the aim of which was to mobilize more capital into job-creating startups.

The current thresholds under Section 1244 were last updated in 1978, which are: First \$1,000,000 of outside, individual tax payer(s) (angel investors) capital gets 1244 treatment; \$100,000/yr of 1244 losses deductible against ordinary income (for joint tax return); and \$50,000/y of 1244 losses deductible against ordinary income (for filing single).

The Consumer Price Index has risen 363% since 1978. If the above thresholds were inflation adjusted, the levels would be: \$3,630,000 of outside investors' capital would qualify for de-risking under 1244; \$363,000/yr of 1244 losses could be deductible for joint filers; and \$181,500/yr for single filers.

Conclusion

Tax reform is a key opportunity to help startups grow and thrive, existing small businesses to better compete and take more risks through smart investments, and encourage greater levels of entrepreneurship. SBE Council and our team of experts and small business member-advisors look forward to working further with the Small Business Committee to identify additional opportunities to fix the tax code for entrepreneurs, and advance a bill to the President's desk for his signature. Thank you for the opportunity to submit this statement for the record.

SBE Council

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242-5840**

sbecouncil.org • @SBECouncil

